Legal Services Policy Institute

August 2009

WIDER ACCESS, BETTER VALUE, STRONG PROTECTION

Response to the Legal Services Board's Consultation Paper

1. The nature of this response

The College of Law created the Legal Services Policy Institute at the end of 2006 as part of its charitable foundation. Given the College's heritage and growing reputation for strategic leadership in legal education in recent years, the Institute represents its contribution to the process of policy formation and to better-informed planning in legal services by everyone concerned.

This response is submitted on behalf of the Institute addressing the policy and public interest issues raised by the Consultation Paper.

2. Introduction

The Institute is in broad agreement with the Board's approach to alternative business structures as set out in the Consultation Paper. We would wish, however, to sound four notes of caution:

(1) For reasons we explore in detail later in our response, we believe that it is very important for the LSB to strike the right balance between seeking both 'public good' *and* 'market failure' outcomes from regulation in the legal services market, and we are concerned that there is potential for the latter to prejudice the former.

(2) While we accept that 'light touch regulation' is not an attractive notion, we hope that the understandable desire of the LSB to press ahead with ABSs will not result either in too little attention being given to some of the necessary detail, or in too much delegation to licensing authorities who will be left to work out some of this detail for themselves.

(3) Any market development, structural response, or individual ABS licence application that puts (or is likely to put) pressure on the independence of

legal advice or on the professional principles must be thoroughly investigated and resisted.

(4) A failure or unwillingness to regulate positively to ensure competence (particularly of a Head of Legal Practice and Head of Finance & Administration) will in our view exacerbate the risks of ABSs.

3. Responses to the consultation questions

We now respond to the specific questions posed in the Consultation Paper on developing a regulatory regime for alternative business structures.

Question 1. What are your views on whether the LSB's objective of a mid-2011 start date for ABS licensing is both desirable and achievable?

In principle, we believe that a mid-2011 start date is both desirable and achievable. However, such a tight timeframe is not without risks. It is therefore important that the start date is subject to considering appropriate evidence from stakeholders and making risk-based judgements.

There are incumbent law firms and new entrants wishing to take advantage of the opportunities offered by the ABS framework. Their contribution to the market for legal services will help to deliver the objectives and consumer benefits of such liberalisation. It seems reasonable for three reasons for ABS licensing to be in place sooner rather than later:

(a) to encourage the realisation of the intended market and consumer benefits;

(b) to reduce the uncertainty faced both by would-be licensees in preparing their applications and by their competitors in understanding the nature of the competition they will face; and therefore

(c) to reduce the risk of 'anticipatory ABSs' that are tempted to push the limits (or even breach them) of what is currently allowed within the existing professional regulations.

We are conscious of Sir David Clementi's view that multidisciplinary practices (MDPs) represent a greater regulatory challenge and risk, and understand his observation that MDPs should therefore be introduced on a longer timeline than LDPs[1]. However, we believe that MDPs are but one manifestation of ABSs[2]. It is not

[1] *Review of the Regulatory Framework for Legal Services in England and Wales* (2004), Chapter F, paragraph 98.

[2] See Mayson (2007) *Alternative business structures: something for everyone?* (London, LSPI) (available at: http://www.college-of-law.co.uk/about-the-college/Institute-Papers.html).

our view, therefore, that the overall ABS regime should necessarily be held back until there is greater experience of LDPs. Nevertheless, it might be the case that evidence (or lack of it) in relation to certain MDPs will indicate that a more considered approach should be taken. Further, we do not entirely agree with the statement in paragraph 5.13 of the Consultation Paper that "we should not assume that the risks in relation to ABS are substantially different from those already found within legal practices". Our view is that there *are* different risks, not least the mixing of services, and the involvement and influence of non-lawyers, where there is no directly comparable experience (beyond the currently limited experience of LDPs). The more important issue to us is whether these *different* risks pose *greater* risks – either systemically in the market place or individually in relation to a particular ABS.

Some of the potential ABS licensees will wish to apply for licences to operate an ABS because they believe that such a structure will improve their competitive advantage. The precise nature of their plans will therefore be commercially sensitive. Accordingly, the "lack of clarity and consensus about the nature of the risks associated with opening the market to ABS" (identified in paragraph 1.10 of the Consultation Paper) might remain for some time. This will make it more difficult for the LSB, and potential licensing authorities, to acquire the evidence they might wish for in order to frame appropriate licensing rules, and then to make the risk-based judgements that are required.

While wishing to see ABSs introduced into the marketplace sooner rather than later, we do not advocate their introduction as quickly as humanly possible. There is still much necessary work to be done. The Consultation Paper addresses issues at a rather high level of generality, and we feel that with ABSs (as with so many things) 'the devil is in the detail'.

It therefore seems to us that there must presently remain a possibility that a need for a more cautious approach could yet lead to a lengthening of the timetable for the introduction of the licensing framework, or – perhaps more likely – a longer application process and consideration of potential ABS licences. We believe that this must be the case where the risks involved are perceived to be greater, simply because the process of evidence-gathering and assessment should take longer for more radical or higher-risk ABSs (that is, the decision period should be longer as a matter of fact, rather than of regulation[3]). The authority to issue licences should not therefore be granted until the LSB is sure that all the foreseeable issues can be satisfactorily covered in licensing rules.

[3] Given that a licensing authority is committed by statute to reach a decision within 6 months of an application being made (extendable to no more than 9 months: Sch. 11, para 2), it seems to the Institute that a licensing authority must be very clear in its licensing rules about the nature, quality and degree of evidence that will be required to be submitted with an application to ensure that it will be in a position to make an evidence-based and risk-based decision within the period allowed.

Question 2. How do we ensure momentum is maintained across the sector towards opening the market?

To a significant degree, we believe that momentum will be maintained by following the timetable set out in the Consultation Paper so far as is consistent with the available evidence and the Board's assessment of risk. We also believe that the LSB will need to ensure that the approach of approved regulators (particularly the Law Society/SRA) does nothing[4] which is unduly restrictive of or hostile to 'anticipatory ABSs' which are consistent and compliant with current professional regulations.

Question 3. What are your views on whether the LSB should be prepared to license ABS directly in 2011 if necessary to ensure that consumers have access to new ways of delivering legal services?

We would hope that direct licensing by the LSB acting as a licensing authority should not be necessary. However, we believe that it might nevertheless be sensible for the Board to prepare for such eventuality. There are three principal reasons for this view:

(a) it is possible that one or more of the approved regulators might not wish to become a licensing authority (or at least not within a timescale that is of optimum benefit to clients and to its regulated community): the Bar Standards Board might come into this category, leaving barristers who wish to create or join ABSs with a difficult choice to make – particularly if the BSB additionally refuses to change the Bar's code of conduct to allow barristers as individuals to do so;

(b) the LSB's own licensing rules might well be adopted as a model or baseline for or by other licensing authorities; and

(c) the costs of becoming a licensing authority might prove too great for one or more approved regulators and would result in ABSs licences being too expensive; direct licensing by the LSB could in these circumstances allow alternative ABS licensing that might provide some benefits of 'economies of scale' to licensees.

Finally, were the LSB to proceed with its own direct licensing powers, it might also provide evidence to approved regulators who, for whatever reason, might otherwise be inclined to drag their heels on applying for licensing powers that the Board is serious in its intent and could provide an attractive (albeit possibly interim[5]) option.

[4] An example might be the misunderstanding and confusion caused by the SRA's misleading use of the expression 'service company' in the Guidance Note issued in January 2009 on preparing for alternative business structures.

[5] Although it is clear that the LSB has powers under s. 84 of and Sch. 12 to the Legal Services Act 2007 to issue ABS licences where there is no other competent or potentially competent licensing authority, it is not clear

Question 4. How should the LSB comply with the requirement for appropriate organisational and financial separation of its licensing activities from its other activities?

We consider that an approach that parallels the one outlined in the LSB's own proposals for regulatory independence in its consultation paper on that subject would secure an appropriate degree of separation.

Question 5. How do you expect the legal services market to respond and change as a result of opening the market to ABS?

How the market *ought* to respond and change, and how it actually does so, could be two completely different outcomes! In views published in 2007, the Director of the Institute set out a number of opportunities which he saw arising from the changes in the regulation and ownership of legal services businesses[6]. In essence, he postulated six new ownership developments arising from LDPs and ABSs:

(1) mixed lawyers (that is, solicitors with other authorised individuals);

(2) lawyers and managers (where 'manager' is used in its more colloquial sense rather than in its narrowly defined form in the Legal Services Act);

(3) multi-talented practices (MTPs), where lawyers combine in ownership with other individual professionals, such as accountants, surveyors, consulting engineers, health care professionals, estate agents, economists, and so on; the firm still provides legal services as its core business, and the other services represent an adjunct or added value;

(4) multidisciplinary practices (MDPs), where law firms merge with other professional practices or other businesses to provide a range or mix of services and in which the provision of legal services is no longer necessarily the dominant business;

(5) new entrants, where non-law businesses enter the legal services market (often referred to as 'Tesco Law', and perhaps exemplified as an extension of the legal services already offered by, say, Co-operative Legal Services, Halifax Legal Solutions or AA Legal Services); the legal services element might be but one of a number of products and services offered – and possibly not even a core part of the overall business; and

whether, if such a licensing authority is designated after a licence is issued, the licensee must be transferred by the Board to that authority (although s. 73(3)(a) would seem to allow the Board to consider delegating its functions in these changed circumstances).

[6] See Mayson, S.W. (2007) *Alternative business structures: something for everyone?* (London, LSPI) (available at: http://www.college-of-law.co.uk/about-the-college/Institute-Papers.html).

(6) external investors, including public flotation and private equity; more importantly, this development could also include the non-lawyer staff in a law firm being offered shares, share options, or other ownership interests as part of an employee benefits and motivation package.

The first three developments would most likely be internally driven, that is, would be initiated by current law firms and those firms would remain predominantly providers of legal services[7]. The final two (with the exception of staff investment) would be driven from outside existing law firms and, usually, the current legal services market. The MDP option could be driven either internally or externally, but we suspect the reality – given the generally inherent conservatism and risk-aversion of lawyers – is that they would be driven and controlled by non-lawyers.

While the Institute remains broadly in favour of these developments, the Director of the Institute has expressed elsewhere views about the issues and challenges that still remain in the design and effective regulation of alternative business structures[8]. The issues and challenges will determine the emergent shape and efficacy of the legal services market when it is opened up to ABSs.

Question 6. In what ways might consumers of all types – including private individuals, small businesses and large companies – benefit from new providers and ways of delivering legal services?

The Institute believes that the potential benefits are many. However, we consider that it is most likely that the benefits will differ according to the market segments into which clients will fall. For example:

(1) In our view, the *'retail' or 'consumer' client* segment is potentially the most likely beneficiary of new entrants to the market and of new ways of delivering legal services. This group of clients will predominantly be seeking advice and support in relation to moving home and housing issues, wills and probate, personal injury (mainly as a result of road traffic accidents, but including clinical negligence and accidents at work), employment concerns, social welfare and benefits, and family and relationship breakdown issues. We expect that the retail new entrants will bring their expertise and experience of branding, supply chain management and efficiency, and competitive pricing to the market, resulting in providers offering: more accessible services (both

[7] This would be consistent with the present rules relating to LDPs, which require such entities to deliver 'solicitor services'. The idea of the MTP is that the 'other talents' provide related services which add value to the core provision of legal services to clients, rather than (as in an MDP) being promoted and provided as independent professional services in their own right.

[8] See Mayson, S.W. (2008) *External Ownership and Investment: Issues and Challenges* (London, College of Law) (available at: http://www.college-of-law.co.uk/about-the-college/Institute-Papers.html). Many of the views expressed in our response are drawn from this discussion paper, and are further informed by the Institute's Forum on External Ownership and Investment.

physically and virtually) with longer and more client-friendly opening hours, and possibly packaged (either multi-legal, multi-talented or multi-disciplinary) or telephone and online services; an experience and quality of service delivery that is more in line with clients' expectations of consumer services (in terms of, say, attitude, responsiveness, being jargon-free, pricing, and methods of payment); and a different response to complaints (in the sense of being more positive, and focused on resolution[9]).

We would also include within this segment those clients who require legal advice and representation in relation to criminal charges, immigration and asylum. These needs might also be covered by legal aid. In this sense, there could be said to be two 'consumers': the direct client, and the Legal Services Commission/taxpayer. The direct clients could well experience the same benefits from ABSs as those set out above. Perhaps the greatest benefit to the public purse would be the availability of providers of legally aided advice and representation who were established at a degree of scale above that currently found: there could then be direct benefits in terms of legal aid services that are provided more cost-efficiently, as well as the incidental benefit for the Commission of reducing its own administration costs by dealing with fewer suppliers.

Finally for this segment, we consider it unlikely (or certainly less likely) that new entrants with retail brand value (such as supermarkets, banks and possibly insurance companies) will provide consumer legal services that relate to crime, or to relationship breakdown and other family issues (such as disputes relating to financial claims or children). In the case of crime, the consequences of negative brand association are likely to outweigh any perceived commercial benefits. In the case of relationship issues, whatever the outcome of the legal services delivered – and, indeed, irrespective of how well those services are delivered – the likelihood is that both parties will consider themselves in some sense 'worse off' as a result of the experience. Again, the risk of poor brand association could, we suspect, deter some new entrants[10].

(2) *High net-worth individuals, owner-managed businesses, and small and medium-sized enterprises* often have legal and related needs that are intermingled. We think that it is a mistake for law firms to believe that, simply because this group might be better able to afford higher-priced or premium services, clients within it will opt for such services. They are also often 'time-poor', and perhaps even relatively inexperienced in procuring legal and other

[9] See further our response to Question 23 below.

[10] Though the reaction of, for example, membership organisations might be different if they feel that their members deserve a broader range of services than a more commercially minded retailer would prefer to offer.

professional services. As with retail clients, therefore, we consider that there will be scope for the packaging of multi-legal, multi-talented and multidisciplinary services, as well as for online solutions. This group will also welcome more accessible and better quality services that represent value for money.

(3) *Large companies* (and for most purposes we would also include *public sector* clients in this group) will be only incidentally concerned about the ownership and capital arrangements of law firms[11]. However, this client group could benefit from the additional improvement in service delivery and quality, increase in range of services, and the improved morale of staff, that investment or the introduction of more varied talent into the business that ABSs could bring.

Question 7. What opportunities and challenges might arise for law firms, individual lawyers, in-house lawyers and non-lawyer employees of law firms as a result of ABS?

Our response to this question in relation to opportunities is contained within our response to Question 5 above. In relation to challenges, we respond as follows:

(1) We consider that the advent of ABSs and the market response to them generally should (and most probably will) result in the providers of legal services, both large and small, being much more business-like and better managed than has historically been the case with law firms. In turn, this will force their managers to focus on the underlying economics of their businesses and to be clearer about how many employees (whether legally qualified or not) they need and what they need them to do. This is likely to lead to a reduction either in the overall number of qualified lawyers in the marketplace or a reduction in income for some of them. This adjustment in the market for qualified lawyers will be difficult for some firms and lawyers to come to terms with, and we suspect that many will be ill-prepared (which could, in turn, result in some failures of firms, with unknown consequences for clients, run-off liabilities, and successor practices).

(2) Non-lawyer employees could be affected both positively and negatively. On the positive side, there may well be more opportunities for them in the future as they replace qualified lawyers for some activities that are not reserved or do not require or justify the involvement of authorised persons. On the negative side, the adjustment of incumbent firms to more business-like practices might lead to the realisation that they are over-staffed generally

[11] See, for example, KPMG (2008) *Impact of the 2007 UK Legal Services Act: Survey of major companies 2008* (London, KPMG) (available at: http://www.kpmg.co.uk/pubs/312-403.pdf).

resulting in redundancies and fewer job opportunities: these losses might, to some extent, be offset by additional openings in businesses created by new entrants.

Question 8. What impact do you think ABS could have on the diversity of the legal profession?

In principle, the opportunities offered by ABSs should be neutral in relation to diversity. In practice, however, we wonder whether there might be one or both of two effects:

(1) New entrants into the marketplace might be more attuned to diversity issues than some law firms have been, thus improving the diversity profile of the profession. Further, by creating or operating as larger entities, the turnover of staff might be greater, providing more recurrent opportunities to influence the make-up of their staff.

(2) As new entrants move into the retail market, and as smaller firms are encouraged to consolidate or forced to disappear, it is possible that BME law firms could be disproportionately and adversely affected.

Question 9. What are the educational and developmental implications of ABS and what actions need to be taken to address them?

The introduction of ABSs into the legal services market will change the business landscape for regulators, clients, the public, lawyers, non-lawyers, new entrants, investors, lenders, other advisers, and suppliers. Consideration should therefore be given to the educational implications in respect of:

(1) *Clients and the public*: the Legal Services Act includes a regulatory objective of "increasing public understanding of the citizen's legal rights and duties" (s. 1(1)(g)). While this is covered by the current approach to Public Legal Education[12], the LSB will have to address the issues as part of its remit. It will also need to consider whether this should extend to education for clients and the broader public about the sorts of businesses or organisations from which legal services will be available in the future[13], how to make enquiries about resolving or resourcing their legal needs, the terms of engagement that should or might be expected with the providers of legal services, and the resolution of complaints.

[12] The Public Legal Education Network has a current site at www.plenet.org.uk. The Ministry of Justice also convenes a PLE Strategy Group, chaired by a minister.

[13] This could extend to sources and funding of advice, including law centres and other advice agencies, services provided *pro bono*, on-line enquiry and provision, legal aid, and so on.

(2) *Lawyers*: thought should be given to the need for any changes to the educational requirements for qualification, and for continuing professional development[14]. Depending on the view taken by the LSB and licensing authorities, there might be a case for specific training for those lawyers who seek designation as a Head of Legal Practice (HoLP)[15].

(3) *Non-lawyer managers, investors and new entrants*: again, depending on the view taken by the LSB and licensing authorities, there might need to be specific training for those non-lawyers who:

(a) are involved in the delivery or support of legal services (including their duty under s. 90 not to cause or substantially contribute to a breach of professional obligations by lawyers);

(b) become owners or managers in ABSs (including an understanding of the nature of reserved legal activities, the duties of lawyers, and the obligations placed on them by the Act, the licensing rules and the specific terms of their licence); or

(c) seek designation as a Head of Finance and Administration (HoFA) (their qualifications and duties)[16].

(4) *Licensing authorities*: the circumstances surrounding and leading up to the Law Society commissioning the review of corporate legal work by Nick Smedley[17] demonstrate the dangers of a regulator being perceived to be ill-informed and out of touch by those whom it seeks to regulate. The Institute therefore believes that consideration must be given to the training and development arrangements required of licensing authorities to ensure that they are competent to license, regulate and monitor ABSs within their domain.

In all cases, of course, there remains the key question of the precise nature (and provider) of any education or training required, and of any qualification, certification or accreditation required or accepted as evidence of competence or suitability for appointment. We see much force in the view that, once their non-lawyer managers and key officers have been approved as 'fit and proper', ABSs might reasonably be left to determine for themselves the training and development

[14] The Institute believes that a more fundamental and strategic reappraisal of training for the delivery of reserved legal activities and leading to a professional title should be undertaken. We refer the LSB to our forthcoming papers, *Training for the Future: the professional preparation of lawyers for the commercial and regulatory environment after the Legal Services Act 2007*, and *The Accreditation of Learning Programmes Leading to Professional Legal Qualifications*, due for publication in September 2009.

[15] See also our response to Question 18 below.

[16] See also our response to Question 18 below.

[17] See Smedley, N. (2009) *Review of the Regulation of Corporate Legal Work* (London, The Law Society) (available at: http://www.legalregulationreview.org.uk/files/report_smedleyfinal.pdf).

needs of their staff. However, experience of the real value of mandatory continuing professional development (CPD), as well as the frequency of defaults in compliance with CPD obligations, do not fill us with confidence that such an approach will secure for clients and the public the necessary degree of up-to-date competence that they are entitled to expect under the regulatory framework overseen by the LSB. Responsibility at the entity level (principally through the HoLP or HoFA) for encouraging compliance by individuals with their CPD obligations might usefully become a term of ABS licences.

Question 10. Could fewer restrictions on the management, ownership and financing of legal firms change the impact upon the legal services sector of future economic downturns?

We consider that the framework of regulation relating to management, ownership and financing of legal services providers envisaged by the Legal Services Act is, in principle, sufficient to achieve the regulatory objectives, preserve professional integrity and quality in the delivery of legal services, and secure sound and sustainable financing. We express in our response to this Consultation Paper (as well as in other published comments about the Act and its implementation) specific instances where we hope that a 'light touch' or 'easy way out' will not be adopted in the realisation of the detail of that framework. We therefore hope that there will not be "fewer restrictions" than those envisaged by this framework. On that basis, we do not consider that any future economic downturn would affect the legal services sector any differently than has happened in the past.

The risks pertinent to the sector arising from a downturn seem to us to relate principally to:

(a) financial pressure on law firms to cut corners, compromising results for the client or quality of service (or both); and

(b) the temptation for lawyers to take money from client account.

As long as the relevant provisions remain in place for the maintenance of professional obligations, run-off liabilities and indemnity cover, successor practices, and intervention by the approved regulator or licensing authority, we do not consider that an economic downturn in the future will lead to any significantly raised risks from ABSs. By implication, if the "fewer restrictions" envisaged by Question 10 would entail removing or reducing these protections, we would (subject to the detail) express concern.

Question 11. What are the key risks to the regulatory objectives associated with opening the market to ABSs and how are they best mitigated?

We consider the greatest risk to be that we expressed as part of our response to Lord Hunt's legal regulation review[18]. We believe that too much of the rhetoric surrounding the Legal Services Act – and, indeed, the Board's own statements – privilege a market-based approach at the potential cost of not achieving effective regulation to secure the 'public good' dimensions of access to justice, the maintenance of the rule of law, and the effective and efficient administration of justice[19]. In other words, our concern is that any failure to draw a sufficient distinction between regulating to achieve a public good and regulating to avoid market failures is likely to lead to a distortion of the regulatory objectives. Our conclusion on this issue, as expressed to Lord Hunt, was[20]:

> We believe that the approach we are advocating is consistent with the recent shift away from the dominance of free-market ideology and the 'efficient markets hypothesis'. It now appears to be accepted that markets do not always (and arguably never can) price goods and services effectively on the basis of freely available and full information, do not always effectively redistribute risk, and are not peopled by buyers and sellers who always behave rationally. In those circumstances, regulation is not only justified but necessary. As Blond (2009) recently put it[21]: "Since markets are essentially amoral, it follows that they should be directed by a moral account of what we want them to achieve". In the context of legal services, we believe that this moral account is provided by greater attention to the public interest and public good dimensions.

In relation to some of the other specific regulatory objectives:

(1) ***Encouraging an independent, strong, diverse and effective legal profession:*** We recognise the point and the desirability of the principle which underlies the *cab-rank rule*. We believe that the rationale for the rule is best identified

[18] See Legal Services Policy Institute (2009) *Legal Regulation Review: response to the independent review by Lord Hunt of Wirral*, para 2.1 (available at: http://www.college-of-law.co.uk/about-the-college/responses-to-consultation-papers.html).

[19] For example, in the first issue of *Legal Compliance Bulletin* (2009), page 7, the Director of the Institute referred to the Board's business plan: "The LSB business plan in many places refers to the supremacy of the interest group of consumers: for example, in paragraph 1 ('reform and modernise the legal services market place in the interests of consumers'), and paragraph 20 ('any regulatory regime must put the interests of consumers first'). There is no doubt that, in the pursuit of the public interest, consumer interests need addressing: legal services must be meaningful and available. But there may also be times when consumer interest should not prevail over the public interest (the availability of funding for legal aid might be one such area of incompatibility, and the mandatory disclosure of evidence or authorities to another party likewise): in no sense should this result in the consumer interest being put first. In a similar vein, perhaps the most disappointing (and potentially dangerous) statement in the business plan can be found in paragraph 11: 'it is ultimately for the market to determine how best to meet consumer needs'. With respect, it is not; that is why we need regulators and a Legal Services Board. It is why the public interest requires transparent, accountable, proportionate, consistent and targeted regulation. If any lesson has emerged from the financial crisis currently engulfing us, it is that markets do not always know best. Regulators must take more than a watching brief."

[20] Cf. footnote 18 above, paragraph 2.1.

[21] Blond, P. (2009) 'Let us put markets to the service of the good society', *Financial Times*, 14 April, page 11.

as the 'flip side' of a professional monopoly, namely that barristers cannot claim a professional monopoly and then be selective about the circumstances in which they are prepared to represent clients[22]. However, the removal of that monopoly with the advent of solicitor-advocates suggests that the rationale for the rule in relation to the Bar has been undermined. We are not persuaded that the cab-rank rule remains a necessary, defining feature of self-employed barristers, however desirable in principle the existence and reality of the rule might be.

Further, there is an underlying tension that is hard to reconcile or justify. On one hand, the Bar is being pressed to undertake conditional fee work, and to become more businesslike in their working structures and practices (particularly, but not exclusively, in relation to publicly funded work where arrangements for block or volume contracting, and the combination of litigation and advocacy, are increasingly viewed as the way forward). On the other, there is a professional obligation in the cab-rank rule which deprives individual barristers of the freedom to make commercial decisions. The ABS framework is the likely mechanism through which a number of the necessary new structures will be implemented.

We therefore believe: (i) that the cab-rank rule has in practice become a largely 'elective' professional obligation, having been disapplied by the Bar Council in relation to publicly funded criminal and family advocacy, as well as being easy to avoid for those barristers who prefer not to be bound by it; but (ii) that, if the rule is to be retained, it should be applied to all advocates (whether barristers or solicitor-advocates) as a professional obligation[23].

We are also not persuaded that *conflicts of interests* arising from barristers entering into partnership or other business structures with each other or with other professionals represent a sufficient reason for arguing that the public interest requires the continuing prohibition on such arrangements because of the likely reduction in access to justice to which those conflicts will necessarily lead. Clearly, the public interest requires that no lawyer should be tempted to put self-interest ahead of his or her duty to the court or of obligations to clients (we return to this in (2) below in expressing our views about the professional principles). Alternatives to self-employed sole practitioner status for barristers would provide options; they would not

[22] This view was articulated by Lord Oliver during the passage of the Courts and Legal Services Act 1990: House of Lords Debates, Vol. 1454, col. 1197 (25 January 1990).

[23] Indeed, we have argued elsewhere – and would repeat here as a matter of public interest in the quality and consistency of advocacy, and of clarity to consumers – that our view is that all advocates, whatever their professional qualification and experience, should abide by the same professional rules and standards and should be held accountable to the same obligations (cf. Legal Services Policy Institute (2008) Response to SRA consultation on *Standards for Solicitor Higher Courts Advocates and Outline Proposals for a New Accreditation Scheme*, page 4 (available at: http://www.college-of-law.co.uk/about-the-college/responses-to-consultation-papers.html)).

replace the current mandated structure with others. Potential conflicts of interest would become one element of the commercial decision that barristers would have to take into account in deciding whether or not to adopt one of the new forms.

To suggest that partnerships or other forms of collective endeavour would potentially deprive a client of the barrister of their choice is, of course, true; to conclude that this is a basis for denying barristers their own choice of business structure is, however, misguided. Partnerships of solicitors result in the same potential loss of choice for clients: no-one suggests that this is against the public interest or restricts access to justice. If there are quality advocates available elsewhere, the loss by one firm or set of chambers will be another's gain: in the system as a whole, there would be no net reduction of work. To our mind, the crucial issue is the *quality* of advocates available, not the *business form* or source through which their services are available.

Further, the consolidation and growth of both law firms and sets of chambers have been apparent for a number of years. The principal risk to access to justice seems to us not to be the loss of independence of advocates through their choice of personal or collective practice structures, and the greater likelihood of conflicts arising because of the increasing size of the entities providing legal services. Rather, the potential compromise to independence seems to us to arise from the combination of litigation and advocacy within the same business entity. However, even this is not something that we would argue should result in regulatory prohibition or discouragement. The real question should surely be whether a client is denied access to justice because the firm puts its collective economic interest in retaining advocacy in-house ahead of acting in the best interests of the client in instructing a better advocate externally. We see this not as a structural issue, but as one of integrity, and therefore as a matter of transgressing the professional principles. At one level, therefore, this conflict is not unique to ABSs; however, we suspect that their popular manifestation would increasingly be through ABSs.

We return to the broader issues of conflicts of interest and loss of independence arising from external ownership or investment in ABSs in our response to Question 13 below.

Referral fees paid by lawyers for the acquisition of work pose particularly difficult issues. At one level, all businesses face 'costs of acquisition' of new work – in advertising, marketing, prospecting, networking, meetings, tendering, and so on. Some are clearly quantifiable; others are investments of time and effort; some costs are directly attributable to new business acquired, while others are 'acts of faith'; all involve some element of opportunity cost. From a business perspective, the rational course would be

to invest in those acquisition methods which, over time, proved most successful and cost-effective in producing new work[24].

From an ethical perspective, however, there remain two residual concerns. First, reliance on a source of work might be perceived to compromise a lawyer's independence and lead to (if only self-imposed) pressure to act in ways that are not entirely in the client's best interests. Second, depending on the level of the referral fee, the difference between the referral fee and what the lawyer might be able to charge in respect of the work to be undertaken might be squeezed to a level that questions the economic viability of the type of work or specific matter involved, again leading to pressure on the lawyer to cut corners and to do things that are not in the client's best interests or possibly inconsistent with the lawyer's duty to the court[25].

Nevertheless, we would observe that banning referral fees would have other consequences. Referral fee income for those who control referrals to law firms would have to be replaced: this would almost certainly lead to higher costs or premiums to their customers or insured. Insurance companies are able to some extent to use referral fees to reduce loss ratios and so hold down the level of premiums. However, given that there is an element of such costs being 'passed around' the insurance industry as, for instance, claimants' costs are picked up by defendants' insurers, such effects on premium levels are not entirely clear. There are also differences between the regulatory structures for insurance companies and claims management companies which do not encourage a level playing field.

Law firms previously paying referral fees for client work would also face alternative (possibly higher) acquisition costs that they would wish to be reflected in their fees to clients. Dismantling what has become a widespread practice and source of income for referrers, and a commercial necessity for law firms seeking supplies of work, would now present many regulatory and practical challenges.

While accepting the objective of opening up a more competitive and cost-effective legal services market through external ownership and investment, the Institute remains concerned that the statutory objective of securing an independent legal profession might be, or be perceived to be, compromised by the use of some referral arrangements. Further, some of those arrangements overtly highlight the tension between lawyers' professional obligations and their economic interest, and we believe that licensing authorities should remain alert to the existence of referral arrangements and

[24] Some law firms that systematically track costs of acquisition have evidence suggesting that referral fees do in fact represent for them the most cost-effective basis of work acquisition.

[25] This could be particularly the case for work in respect of which there is a fixed upper limit on the recoverability of charges by the lawyer (as, for example, in some personal injury work).

the influence they could exert on the professional independence, obligations and judgement of authorised persons within ABSs.

For these reasons, while as a matter of principle we might prefer the avoidance of any suggestion of professional independence and integrity being tainted by the payment of referral fees, we doubt that at a pragmatic level such payment could now be effectively prevented[26]. Instead, our view would be that the rules relating to the payment of referral fees should be common and consistent across regulatory authorities[27] in order to maintain a level competitive playing field, and that their payment should be entirely transparent to the clients involved so that they may make their own fully informed judgement about whether to continue to instruct a lawyer who has paid a referral fee. Whether there should be any residual discretion for regulators or judges to prevent referral fees absorbing a disproportionately high percentage of the ultimate fee that may be charged for the work done is an issue that in our view merits serious further consideration (and we have put this view to Lord Justice Jackson's review of costs).

Of course, if those providers of work who currently receive referral fees from lawyers were to choose to internalise legal services by creating ABSs, it is possible that the incidence of referral fees could reduce or disappear.

(2) ***Promoting and maintaining adherence to the professional principles:*** We believe that the statutory framework relating to the professional principles is comprehensive and robust. The ethical reality of an ABS will rest with the behaviour of its owners, investors and staff, the integrity of its HoLP and HoFA, and the effectiveness of regulatory oversight by its licensing authority and the LSB. Many (if not all) of the issues that we have raised in (1) above are ultimately matters of professional integrity on which arguably there should not need to be separate regulations or rules over and above the obligation to comply with the professional principles. This takes us to the heart of the debate about rule-based or principles-based regulation.

In our response to Lord Hunt's review, we referred to the shift from rule-based to principles-based regulation and said[28]:

[26] This is certainly the view of the current Chairman of the SRA, despite significant evidence of non-compliance with SRA rules: see http://www.lawgazette.co.uk/opinion/by-the-book/banning-referral-payments-not-practical. However, the parallel debate in the financial services industry about banning financial advisers from taking commissions, and requiring greater transparency in the provision of independent advice (as distinct from 'restricted' advice), raises the prospect of a public or political momentum that could justify a more fundamental and open-minded review.

[27] At the moment, for instance, solicitors may pay referral fees whereas barristers may not.

[28] See Legal Services Policy Institute (2009) *Legal Regulation Review: response to the independent review by Lord Hunt of Wirral*, para 2.2 (available at: http://www.college-of-law.co.uk/about-the-college/responses-to-consultation-papers.html).

> Such a shift is desirable in the face of regulatory infractions in circumstances where the rules have been perfectly clear. What has been missing on these occasions is not regulatory clarity but regulatory compliance. This in turn is usually the result of some failing of process (arguably an inadvertent breach) or of ethical behaviour (and therefore normally intentional).
>
> In the face of ethical failures, compliance with principles rather than rules is attractive. After all, the degree of public understanding of or sympathy with law firms in (say) the miners' compensation cases[29] or with Parliamentarians' expenses claims is slight in the face of the justification that 'we did nothing that broke the rules'. Following the letter rather than the spirit of regulation might be technically compliant but does not necessarily achieve regulatory intentions. However, the challenge for principles-based regulation is its unfortunate connotation with 'light-touch' regulation, and the perceived failing of regulators to deliver the expected outcomes of regulation….
>
> Nevertheless, if principles-based regulation is perceived to be 'light-touch', then it must be allied with some more rigorous articulation of principles-based behaviour – that is, it must have a demonstrably ethical underpinning…. We question whether it is potentially misleading to seek regulatory focus through an approach that is described primarily in relation to rules, principles, outcomes, values or risk to the implied exclusion of other dimensions. It seems to us that any regulatory approach should be founded on some conception of underlying values and principles, should seek to achieve desirable outcomes and address perceived and unacceptable risks, and will need to be expressed in some rules. In other words, what is required is an appropriate mix and balance of approaches. Principles, rules and outcomes must be seen as inter-dependent. Rules should be designed to give effect to principles, which is why we believe that principles must come first. Outcomes must be consistent with both principles and rules….
>
> In short, a successful and effective regulatory system needs principles, rules and appropriate outcomes; it is the relative emphasis and reliance placed on one over the other that determines whether a system is genuinely principles-based.

Encouraging compliance with principles-based regulation is therefore a matter of practitioners having an ethical mindset and commitment to professional integrity. Much can be done to foster this, as the 'education for compliance' approach of the Legal Services Commissioner for New South Wales has demonstrated[30]. Dealing swiftly, fairly and in a robust way with

[29] These cases provide a salutary reminder of the danger of falling into a trap of believing that all lawyers are, by definition, ethical and provide high-quality services and that conversely all non-lawyer-controlled ABSs will inevitably be unethical or provide poor quality services. We have seen lawyers and law firms failing to resist precisely the same commercial pressures and blandishments to behave unethically as are often argued to undermine the policy of allowing non-lawyer ownership or investment.

[30] See Parker, C., Gordon, T. and Mark, S. (2008) *Research report: Assessing the impact of management-based regulation on NSW incorporated legal practices* (NSW Australia, OLSC) (available at: www.lawlink.nsw.gov.au/lawlink/olsc/ll_olsc.nsf/vwFiles/September2008_Research_Report.doc/$file/September2008_Research_Report.doc). This research found that law firms adopting 'appropriate management systems' as required by NSW legislation (and in particular following the ten management objectives and the self-assessment process established by the NSW Legal Services Commissioner, details of which are available at www.lawlink.nsw.gov.au/lawlink/olsc/ll_olsc.nsf/pages/OLSC_ilp) reduced their level of client complaints to a third of the rate existing before self-assessment.

those practitioners who fail to comply with the professional principles will be a necessary step in securing public confidence in the efficacy of those principles, as well as in maintaining the momentum in practitioner compliance. We believe that this will be more effective where there are common professional standards and adherence to them[31]: the issue is the *quality* of service, not the professional *source* or business structure through which the service is rendered. Again, for us, it emphasises the need for attention to public good *as well as* market failure dimensions.

The qualification and freedom to exercise the professional principles is a privilege: the LSB must ensure as the overarching regulator that the privilege is not abused, and it will achieve this by holding approved regulators, licensing authorities and the Office for Legal Complaints strictly and regularly to account for the effective discharge of their respective responsibilities.

We are in favour of the LSB expressly setting out a 'hierarchy of duties' (to the court, to clients, and then to the owners of legal services businesses) as suggested in paragraph 5.17 of the Consultation Paper. Although as a matter of law such articulation might not be necessary, we nevertheless believe that to set it out would be a positive contribution to managing the expectations of those who choose in the future (particularly as non-lawyers) to participate in the ownership, financing or management of legal services businesses.

Question 12. Are there particular types of business structure or model which you consider to present a particular risk to the regulatory objectives?

We would open our response to this question by expressing a general proposition that we would be concerned about any structure, model or incentive which put (or which could encourage, or be perceived as, putting) a lawyer's personal, economic or commercial interest ahead of the professional principles or ran any actual or perceived risk of doing so.

In recent years, increasing concerns have arisen about the bargaining power of 'volume providers' of legal work to law firms, and their ability to dictate terms of business, staff to be engaged on work, methods of delivery to be adopted, and so on. The influence of these large institutional suppliers of legal work (such as insurance companies and banks) and monopsony buyers (such as the Legal Services Commission) is such that the exercise of their power in general, and any desire they might have for acquiring, requiring or encouraging non-lawyer ownership or

[31] Hence our suggestion in response to Question 11(1) that there should be common advocacy standards and a common approach to the cab-rank rule, conflicts and referral fees.

investment interests through an ABS, must be considered carefully and fully in the regulatory framework of the future. If clients are to reap the benefits of competition and improved service delivery, then the potential for deliberate or inadvertent misleading of them by commercial providers about service, reputation, or results, and the transparency of any introduction or referral arrangements (as well as panel selection and internet auction processes), must be addressed robustly. Some would argue that recent experience of third-party capture of, say, personal injury work holds warnings of market distortion and (at best) ambiguous freedom in a client's selection of legal representation.

More generally, the ability of large providers of legal services (whatever their origin) to influence or even distort the market by, for example, increasing their market share, linking legal services and other products and services, or using predatory pricing to drive other (smaller) providers out of the market, should be taken into account as part of the operation of the licensing framework.

From a regulatory perspective, it might be dangerous to anticipate market dominance (which would usually be expected to emerge over a period of time), especially where to do so might deprive consumers of choice. Protecting clients from making a choice based on services being cheaper – albeit possibly more impersonal as well as less responsive – could only be justified by some overriding public policy objective. While there might be a case to suspect indirect discrimination resulting in the inability of certain groups in society to access legal services because of the actions of dominant providers, the supporting evidence for regulatory intervention would need to be compelling. Nevertheless, the purchaser of legal services might reasonably expect protection from the legal equivalent of, say, the on-line risk of buying counterfeit drugs or placebos.

Further, by the time the market dominance of a legal services provider became so dominant that regulatory intervention was required, there would almost certainly have been a 'point of no return' caused by the market exit of alternative, smaller, and more widely distributed, suppliers. There is also no guarantee that the dominance through scale of such providers will have delivered economies of scale or cost-efficiencies of benefit to clients. Scale and dominance could be achieved at the price of the consolidation and exit of smaller suppliers, without any corresponding or consequential cost or efficiency benefits for consumers. We would wish the LSB and licensing authorities to be alert to these developments.

It therefore seems difficult to argue that there is *no* risk in potential market dominance. However, weighing that risk against the need for regulatory intervention will require strong evidence and careful assessment.

It is conceivable that some ABS licences or applications for licences will appear to carry higher risk in their strategic objectives than the legal services market has traditionally been used to. A potential justification for regulatory interest in these

businesses could relate to the heightened possibility of an ABS's collapse from the pursuit of higher-risk objectives, perhaps compromising access to justice or leaving vulnerable or disadvantaged client groups without adequate access to local legal services. There is a challenge to be met in terms of public protection, on the one hand, and regulatory intervention, on the other – especially where that intervention might involve (or be perceived to involve) second-guessing or interfering in strategic business decisions. Even so – and more so in the case of larger or dominant providers – there is usually a greater capacity for larger businesses to accept increased risk, further exacerbating the asymmetry between larger and smaller firms, and between provider and client. Increased dominance and fewer choices of providers for clients also increase the consequences of the collapse of a provider where the risks ultimately prove too great.

A distinction might need to be drawn between risks inherent in an activity (such as diversification or combination of services), and risks that are specific to a firm (arising from its governance, lack of skills, nature or source of funding, and so on). Regulators in our view need to be mindful of both.

The introduction of capital into a relatively small business, or the simultaneous consolidation of a number of smaller businesses, without close attention to integration, could also present risks and potentially be destabilising. Further, while both public and private equity investors could perhaps be expected to undertake rigorous due diligence before investing, as well as to bring management and other experience to effective implementation, we remain concerned, at least for the time being, that there may not be sufficient market knowledge to ensure the success of such investment. Also, such injection of capital would occur at the same time as a significant change in a firm's business model, thus compounding the risks involved.

The risks discussed here seem to us to elevate the importance of adequate indemnity and compensation arrangements (as required by the Legal Services Act) to ensure some protection for clients if inherent business risks lead to failure. They also lead to a debate about the need for some form of 'capital adequacy requirements'. We return to these issues in our response to Question 22.

Question 13. What conflicts of interest do you think might arise in relation to ABSs and how should they be managed?

The Department for Constitutional Affairs suggested that it would be for the LSB to provide clear rules about preventing conflicts of interest in respect of services provided by ABSs (*The Future of Legal Services: Putting Consumers First* (2005), para 6.9). However, in his final report, Sir David Clementi had taken a stronger line on the issue of conflicts in LDPs (*Review of the Regulatory Framework for Legal Services in England and Wales*, Final Report 2004, Chapter F, paras 53 and 54):

> 53. A further concern relates to possible conflicts of interest. A lawyer in an LDP must be in a position to assure his client that he approaches any instructions with an independent mind and no conflict of interest. He must approach any fresh instructions with 'clean hands'. The lawyer may well feel that he is able to do this, but where the owner has an interest in the issue there will be a suspicion (where the lawyer follows his professional duty it would be an unwarranted suspicion) that the lawyer may be influenced by this. It is, therefore, proposed that an LDP may not take instructions on a case where the owner has an adverse interest in the matter. Thus, if a bank were to own an LDP, that LDP could not act for a client on any matter in which the bank had an interest, for example advising a client on loan documentation to which the bank was a party[32]. In this context, by 'interest' is meant a direct interest in the legal outcome of the matter being dealt with, rather than the economic one of an owner wishing to provide a satisfactory, rewarding service.
>
> 54. It should not be permissible for the owner, under the terms of the LDP's regulatory conditions, to interfere in any client case or to have access to any individual client files or client information.

Taken literally, this latter point about access to client information might be thought to undermine some of the strategic or commercial rationale of cross-selling that would encourage new entrants to establish ABSs in the first place – and, if it did, could undermine competition, innovation and one-stop-shops.

The Legal Services Act would seem to place its faith in:

(a) the professional principles (particularly that lawyers should act "with independence and integrity" and "in the best interests of clients": s. 1(3)(a) and (c));

(b) the obligation on licensing authorities to have suitable arrangements in place to ensure that the ABS and any of its managers and employees who are authorised persons maintain those principles (Sch. 11, para 17(2)(b)); and

(c) the duty of the HoLP to take all reasonable steps to ensure that the ABS complies with the terms of its licence and to report any failure to the licensing authority (s. 91(1)).

The Act therefore adopts a less prescriptive approach than the Clementi Report advocated; but it would nevertheless be possible for the LSB and licensing authorities to adopt Clementi's recommendations.

We doubt whether conflicts of interest in the narrow, legal sense, are in substance any different within ABSs from those that arise in the more traditional structures of law firms and barristers' chambers. However, there might be more scope for the

[32] The DCA referred to exactly the same example in *The Future of Legal Services: Putting Consumers First* (2005), para 6.9. However, it did not suggest that there is a clear conflict of interest and that an ABS should not act. Rather, the example is used in connection with the "potential leverage that owners may have on an ABS firm [and which] will depend on the size of their stake in it". In the context of this example, "there is likely to be a higher risk in allowing the firm to act for a client where the bank has an interest". The Department's view therefore seems to be relative rather than absolute.

existence of adverse interests within ABSs where the ownership and management is more structurally and functionally separated from those who deliver legal services to clients. In practice, the view taken by proportionate and risk-based regulation would seem to us to be justifiably different depending on the nature of a conflict or adverse interest or on the nature or extent of a non-lawyer's ownership or influence in the ABS.

Our views on conflicts and adverse interests may therefore be summarised as:

- conflicts rules are required to protect consumers from themselves, but there is a legitimate question in relation to 'sophisticated clients' about whether (and to what extent) informed clients should be able to opt out of that protection;
- there is then a related issue of whether conflicts rules should be applied to prevent entities (as opposed to individual practitioners) acting: the use of 'Chinese walls' might satisfy a 'sophisticated' client being advised by another practitioner in a large firm, but there are serious residual issues of whether such an approach would be appropriate for, say, barristers practising in a partnership or ABS acting for those charged with criminal offences;
- we have concerns about the legitimacy of claims being captured, 'sold', conducted and defended by the same insurance company;
- there must always be transparency of cost and tying-in arrangements; and
- there may be some services where the presumption must be that they should not be combined because of conflicts: this will be particularly true where there are conflicting regulatory obligations, for example, to maintain confidentiality (lawyers) and to disclose (auditors).

Question 14. How should licensing authorities approach entity-based regulation and what are the main differences from the traditional focus on regulating individuals?

We note elsewhere that a shift in focus to the entity as well as the individual ignores a third important dimension – namely, regulating the delivery of a *service* (whether by an individual or an entity): see our responses to Questions 20 and 25 below. In the context of this question, we would also emphasise the importance of not reducing regulatory attention on individuals in preference to entity regulation (i.e., entity regulation is an additional level of attention, not a substitute). We are mindful of recent research suggesting that action against individuals represents a more effective deterrence than action against firms[33].

[33] See the reference within the quotation from Margaret Cole's speech set out in our response to Question 18 below.

Changes in the business entities through which legal services are provided and clients access those services will undoubtedly bring additional risks – resulting from either or both of their structure or operations. Dissatisfaction with new entities and different approaches to delivery might well spark more complaints and claims. The Institute hopes that there will be an early and extensive dialogue among regulators, the new Office for Legal Complaints and indemnity insurers about the perceived risks of these new arrangements. In particular, an investigation of the value of 'appropriate management systems' in reducing complaints (and possibly insurance premiums) should be greatly encouraged[34].

In broad terms, we would not expect insurance issues to be fundamentally different for ABSs, and would not therefore expect to see differential treatment as between law firms and ABSs. However, given concerns about a need for appropriate supervision of reserved activities, we think that insurers might wish to see more frequent (and unannounced) audit visits, and an expert board of management. We also believe that insurers should want to understand the financial structure of an ABS and, where capital is contributed, how freely that capital may be used without undue influence from the owner.

Question 15. Do you agree with our view that licensing authorities should take a risk-based approach to regulation of ABS, and if so, how might this work in practice?

Subject to the comments we made in response to Question 11 above concerning the overall focus of regulation and the need for a 'moral account', we fully accept and support the concept of risk-based intervention. However, just as no market will operate perfectly (thus requiring regulatory intervention), so no regulatory framework will work perfectly either. In taking action, regulators should compare the market and its costs and failings with regulation and its costs and failings[35]. Regulating in the public interest would be justified by a conclusion that the market would otherwise fail to deliver a publicly desirable outcome, and that regulatory intervention is justifiable (either, positively, to achieve a public good or, negatively, to address a market failure) and can be achieved at an acceptable cost.

If risk-based and proportionate regulation is to be a reality, then ongoing methods for data collection and analysis of market conditions and responses would be at least desirable, so that regulators can continue to assess the effects of regulatory intervention or exhortation. Ways should be explored for the results and implications of such research to be passed to and considered by the LSB, the Office for Legal Complaints, regulators and licensing authorities.

[34] Cf. footnote 30 above.

[35] In the absence of such an assessment, it is difficult to see how a regulator could justifiably claim to be introducing 'risk-based and proportionate' responses.

We comment elsewhere on some 'higher-risk' objectives (see our response to Question 12 above), and on 'low-risk bodies' (see our responses to Questions 26 and 27 below).

On a more cautionary note, it seems to us that most 'risk-based assessment' is in fact undertaken on an after-the-event basis. In other words, a failure is analysed as having carried too great a risk. This leads to: (1) regulators taking action to deal with those who, with the benefit of hindsight, are judged to have acted either improperly or rashly; and (2) new rules being introduced to prevent or discourage such high-risk activities in the future. Such consequences can legitimately be said to be 'risk-based'; but the value of these approaches in assessing anticipatory risk is highly questionable. This may be even more true in the case of new risks as opposed to those ventures or activities that could be said to represent heightened risk rather than novel risk.

We would therefore express significant concerns in relation to risk in two contexts:

(1) In the wish to introduce and facilitate reforms which are 'in the consumer interest', the voices of caution expressed in support of the public good dimensions of legal services that we highlighted in our response to Question 11 above might not be sufficiently heard or heeded until unacceptable risks have materialised.

(2) The identification and expression of risk by those (perhaps predominantly currently practising lawyers) who advocate a need for prudence or less haste in moving to new business structures and methods of delivery are likely to be dismissed or disregarded as self-serving special pleading. While not doubting that there could well be some elements of this, we urge that not all representations of concern should be met with this reaction. The articulation of a vision by the LSB for the legal services market that it expects to evolve over time will provide some basis for assessment of the direction of intended travel and the associated risks. Combined with a rigorous approach to evidence-based (as well as risk-based) responses, the chances of any such dismissive reaction will be minimised.

Question 16. What is your preferred balance in regulating ABS between a focus on high-level principles and outcomes and a more prescriptive approach?

Our general views on the 'principles and outcomes' focus were expressed in response to Question 11 above.

We agree with the LSB's statement in paragraph 1.10 of the Consultation Paper that it is important to distinguish between risks that are already a feature of the legal services market and those which arise from a more open market. It seem to us to follow from this proposition, and other observations in our responses, that where

there is a perceived (identifiable and ideally quantifiable) risk arising from a more open market there is a strong case for a more prescriptive approach to address that risk. In this way, an approach to ABS regulation can evolve which identifies specific potential 'mischiefs' that regulators wish to address, and to which they can then target specific evidence-based, risk-based and proportionate responses. We therefore would not find it helpful to advocate a generalised preference for either a principled or prescriptive approach.

Question 17. What are the advantages and disadvantages of a requirement on ABS to have a majority of lawyer managers?

Sir David Clementi was quite clear that, as a matter of principle, lawyers should be in the majority by number of managers (*Review of the Regulatory Framework for Legal Services in England and Wales*, Final Report 2004, Chapter F, paras 61, 69 and 101). His rationale was that the majority should be "committed through qualification to the ethical standards to be expected of a law practice" (para 69).

The Government did not incorporate this limitation into the Act, preferring a more permissive framework. Nevertheless, the Government had envisaged in the White Paper that degree of ownership would remain a policy issue for consideration by the LSB (see *The Future of Legal Services: Putting Consumers First* (2005), para 6.5). It would, therefore, still remain open to the Board or licensing authorities to adopt a policy of refusing licences when a restricted interest exceeds 49.9% or alternatively (in a mirror image of the approach to a 'low-risk body'), impose more stringent regulations or conditions on licences where lawyers are not in a majority of management or control of the ABS.

However, we do not consider in principle that ownership of ABSs should be restricted or that lawyers should be required to form any minimum percentage of ownership. Nor would we be in favour of a requirement that lawyers should form a majority or any minimum percentage of an ABS's governing body or management. Nevertheless, we think that it would be sensible to have the HoLP and HoFA as board members – although we make this suggestion as a matter of good practice rather than something that should become a requirement of ABS licensing rules or of an ABS licence[36].

[36] Although in circumstances where a licensing authority perceives risk, it could make one or more of such appointments a condition of a particular ABS licence; cf. Legal Services Act 2007, ss. 85(4) and (6), and Sch. 11, para 10(1)(b).

Question 18. What are your views about how licensing authorities should determine whether a person is a 'fit and proper person' to carry out their duties as a HoLP or a HoFA?

In relation to the HoLP and HoFA (who occupy key management and compliance roles in ABSs), we note that licensing rules *must* make provision about "the procedures and criteria that will be applied by the licensing authority when determining … whether an individual is a fit and proper person" to carry out the duties of the post (Sch. 11, paras 12(1)(a) and 14(1)(a)). These provisions would be broad enough to support specific rules relating to the appropriate evidence of competence, education and training of the HoLP and HoFA.

Within the context of the Act, the role of HoLP assumes a significant and pivotal importance in ensuring professional integrity in the delivery of legal services through ABSs. Consequently, the specific approach of licensing authorities and the content of licensing rules relating to the qualification and approval of, and discharge of duties by, a HoLP will be of vital importance.

The nature of a licensing authority's conditions or procedure for determining whether someone is a 'fit and proper person' to be designated as a HoLP (Sch. 11, para 11(4)) will be crucial. The Institute's view is that the requirement that a HoLP must take all reasonable steps to carry out the duties in s. 91[37] does not mean that a lawyer who is an authorised person in relation to one of the reserved activities for which the ABS has its licence (cf. Sch. 11, para 11(3)(b)) is automatically or necessarily to be regarded as a fit and proper person to be designated as a HoLP. For example, we can see an argument that, say, a notary or licensed conveyancer would not inevitably represent a sufficiently 'fit and proper' HoLP for an ABS that conducted a significant volume of litigation or advocacy.

One of the driving forces leading to the Clementi review was the number and nature of complaints against lawyers and law firms. Many of these complaints at their root concern poor 'management'. It is on the basis of this, as one of the starting points of the Clementi reforms, that we oppose the notion that those who are legally qualified should, without more, be deemed to be suitable to occupy a pivotal management role in ABSs. We also do not accept that a firm should (as paragraph 6.25 of the Consultation Paper suggests) be assumed to "have satisfied itself that the manager has the requisite skills for the role". Law firms have in our view proved insufficiently reliable in assuring the management competence of their lawyer-managers: they have, in other words, not demonstrated that they are capable of forming or exercising a robust basis of judgement for assessing this competence.

[37] That is, that the ABS complies with the terms of its licence, that lawyers act in accordance with the requirements of their professional regulator, that non-lawyers do not contribute to a breach by lawyers of their professional obligations, and that any failures of compliance by the ABS, its lawyers or non-lawyers are reported to the licensing authority.

The Institute argued in its response to the SRA on the issue of character and suitability of non-lawyer managers in LDPs that the new legislative and regulatory framework provides an opportunity for regulators to address, define and supervise the competence and quality of management in the delivery of legal services:

> The new statutory framework of the Legal Services Act 2007 should encourage law firms and regulators to improve the ownership and management of those entities that deliver legal services. Entity regulation provides an opportunity to decide what competence and skills should be required of those in ownership and management positions. Rather than extending a 'professions' approach to ownership that assumes that those who are legally qualified are suitable and competent to own and run a business, the issue of who is suitable to be a 'manager' should be addressed from a different starting point. The days of the more-or-less 'gifted amateur' and 'reluctant managing partner' approach to law firm management need to be laid to rest. Defining the competences required is an important and necessary development in securing the confidence of clients and the public that the entities providing legal services are managed effectively and efficiently. It is also, in our view, a necessary part of the process of reducing the number of complaints against providers[38].
>
> Law firms in the future will need the skills and competences of properly trained and experienced managers who are able to combine that background with the principles of professionalism and compliance with the regulatory framework.

We would again urge that this opportunity is taken in relation to the HoLP and the HoFA in ABSs. We recognise that such an approach presents challenges. However, we note with surprise and disappointment the LSB's comment in paragraph 6.26 of the Consultation Paper that "we do not consider it either feasible or appropriate for regulators to define robust and enforceable criteria to assess the suitability of an individual for a general management responsibility". Such a view seems to us to reflect the oft-expressed prejudice of those who are professionally qualified that the practice of 'management' is in some way not capable of reaching the same degree of intellectual rigour and professionalism as their own discipline, and can, in fact, be undertaken by anyone as an adjunct to their own professional qualification and practice. We believe that other avenues of insight and support (such as the Chartered Management Institute) could and should be explored.

Our intention would be that, in the public interest and with an eye to consumer protection, some degree of publicly verifiable qualification, certification or accreditation for the HoLP and HoFA should be explored as an alternative to the subjective and potentially self-justifying assessment by a firm of its own staff.

We are further comforted in our view by recent comments of Margaret Cole, Director of Enforcement at the Financial Services Authority[39] (emphasis supplied):

> We have frequently stressed the importance of senior management responsibility and oversight. But, some of you might think that we haven't matched our words with decisive action. Well, a recent study by Deloitte for the OFT confirmed what we already suspected,

[38] Cf. footnote 30 above.

[39] In a speech on 18 June 2008 to the Enforcement Law Conference (available at: www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0618_mc.shtml.

> that *action against individuals has a lot greater impact in terms of deterrence than action against firms*. So we know that taking enforcement action against individuals is a vital part of achieving credible deterrence overall. So, you can expect to see more Supervision and Enforcement focus on individuals – especially SIF[40] holders.
>
> Previously for SIF holders, we've tended to focus on cases of dishonesty or lack of integrity where prohibition or withdrawal of approval was the most appropriate outcome. *In the future, we will also consider the competence of SIF holders*, and we won't shy away from pursuing cases against individual SIF holders who breach our Principles and Code.

We would consider that the HoLP and HoFA occupy a 'significant influence function' within an ABS, and therefore urge the LSB to consider further the competence requirements of the holders of those roles. We do not consider that these requirements would be extensive or unduly onerous. It is obviously a statutory requirement that the HoLP should be an authorised person in relation to at least one of the reserved licensed activities of the ABS (Sch. 11, para 11(3)(b)), although, as indicated above, we are not necessarily convinced that this is sufficient in and of itself to conclude 'fitness' or competence. Further, it seems reasonable to us to identify a number of possible acceptable qualifications for a HoFA (such as chartered accountant, chartered secretary, chartered manager, or possibly an MBA degree from a recognised university).

However, in the case of both the HoLP and the HoFA, we believe that a 'fit and proper' holder of those positions should also either demonstrate that they have undertaken a (short) programme that equips them to understand the professional and regulatory framework of an ABS, or undergo an interview with the licensing authority to demonstrate that understanding (or both). It is tempting to argue that this should not need to be a requirement for approval. However, having met many solicitors in the years since the Clementi Review was undertaken who are unable to say what are the reserved legal activities for which they are already authorised persons, we do not subscribe to the light-touch approaches to 'passporting', 'grandfathering' or assuming competence as contemplated in the Consultation Paper.

Question 19. What is the right balance between rejecting 'higher-risk' licensing applications and developing systems to monitor compliance by higher-risk licensed bodies?

It must be an inevitable consequence of a risk-based and proportionate approach to regulation that regulators do not seek to eliminate risk from the market. It might therefore follow that the LSB and licensing authorities should not automatically seek to refuse licensing applications where they perceive that higher-risk objectives are

[40] Significant Influence Functions.

being proposed[41]. In these circumstances, we would expect either that additional conditions or safeguards might be imposed on the licence, or that closer or more frequent monitoring of the ABS's performance and operations would be undertaken (or both).

However, we are bemused by the suggestion in paragraph 6.32 that the "objectives of these visits might be to satisfy the regulator that the right corporate culture and governance arrangements are in place". We do not, of course, believe that regulators should not investigate and require assurance on issues of conflict and professional principles. But we are surprised by the contrast in the LSB's views that, on the one hand, there is an insufficient basis for assessing management competence while, on the other, it is quite reasonable to expect regulators to assess "the right corporate culture". If anything, we would take the opposite view!

It seems to the Institute that the correct balance is for licensing authorities:

(1) to seek clear evidence (and possibly an independent market impact assessment paid for by the applicant) of relative risk in the objectives underlying licensing applications, and to make case-by-case assessments;

(2) to be more cautious in issuing licences to, and to impose more stringent licensing conditions on, those ABSs which set out to pursue higher-risk objectives;

(3) to require more robust corporate governance arrangements, and possibly more evidence of the management competence, background and experience of the HoLP and HoFA, of such higher-risk ABSs; and

(4) to engage in closer and more frequent monitoring of such ABSs.

We understand the basis of the comment in paragraph 6.30 of the Consultation Paper that there may be "some increased risk of firms failing and/or of consumer detriment, at least in the short-term". Nevertheless, we believe that regulators cannot afford to be either too uncritical or too judgemental in their assessment of degrees of risk, and must do all they can to protect consumers from the consequences of inherently riskier ventures and from less experienced operators.

Question 20. How should regulators ensure a level playing-field between regulated legal practices and licensed bodies?

The introduction of entity regulation in our view presents an opportunity for parity of treatment. The imposition of duties of compliance on licensed bodies that mirror very closely those imposed on regulated legal practices creates something of a level

[41] We also agree with the statement in paragraph 6.33 of the Consultation Paper that "some ABS may be lower-risk than some legal practices, so we expect regulators to avoid blanket assumptions about relative risk levels".

playing field in relation to, say, the promotion and protection of professional principles and approaches to dealing with conflicts of interest and legal professional privilege, as well as the need for compensation and indemnity arrangements.

However, there remain some possibilities for lack of parity – some of which arise from the philosophy of competition inherent in the Clementi Review:

(1) *Different regulators adopting different approaches to the regulation of authorised persons*: the LSB's oversight regulation must address the minimum standards required for protecting the public and consumer interests and for maintaining the professional principles. Licensing authorities might wish to set higher standards in order to encourage and secure a greater degree of professional performance and integrity from their regulated community (presumably on the basis that this will offer competitive advantage to their regulated suppliers of legal services for which clients will be willing to pay a premium, having been persuaded that this gives them increased quality). Examples might include:

- the SRA and Council for Licensed Conveyancers adopting different approaches in relation to reserved instrument activities;
- the SRA and the Bar Standards Board adopting different standards of competence or accreditation in relation to higher courts advocacy;
- the SRA and the Institute of Chartered Accountants adopting different approaches in relation to probate activities.

We see no inherent 'mischief' in such differentials, provided the suppliers involved are honest and transparent in their claims and comparisons – whether claiming equivalent competence or performance at a lower price or greater competence or performance at a higher price.

(2) Our principal concern, however, relates to the *possibly disproportionate burden falling on regulated practices in relation to their provision of non-reserved legal activities*. We return to this issue in our response to Question 25 below. The reserved and non-reserved of ABSs will fall within the regulatory reach of licensing authorities[42]. However, the SRA might consider adopting the same policy in relation to ABSs it regulates as it does for solicitors, namely that reserved and non-reserved activities must all be conducted within the same regulated business entity[43]. Thus, depending on the policy adopted by the LSB and licensing authorities, if ABSs are generally allowed to 'hive off' their non-reserved activities into an unregulated business, but those regulated by (say) the SRA are not, there will not be a level playing field. Further, if all

[42] Section 85(7) allows conditions to be attached to an ABS licence "as to the non-reserved activities which the licensed body may or may not carry on".

[43] See Rule 21 of the Solicitors' Code of Conduct 2007 (the 'separate businesses rule').

> ABSs were required to comply with a no-separation rule then, although there would be a level playing field as between ABSs, all regulated legal practices and licensed bodies would be at a competitive disadvantage in relation to unregulated businesses which choose only to supply non-reserved services (which would not need to be – and, indeed, could not be – regulated[44]).

The absence of a level playing field as it would relate to providers who are, or who choose to be, regulated by different approved regulators or licensing authorities, lies in the 'regulatory gap' inherent in the Legal Services Act, that is, that although the regulatory structure now extends beyond regulating individual professionals and providers to the entities through which legal services are delivered, it still does not extend to any consistency of approach to specific legal *services* provided by individuals or entities. The consumer might therefore still be faced with variety and disparity of regulation applying to the same legal service, depending on whether it is provided by a regulated or non-regulated individual, or a regulated or non-regulated entity. At a basic level, therefore, the LSB is statutorily hampered in its wish to provide parity of regulation, or at least some degree of a level regulatory playing field.

Question 21. How should licensing authorities approach the access to justice condition, and do you agree that it is unlikely that many licences should be rejected on the basis of the condition?

The Institute believes that there is frequently an unfortunate conflation of 'access to justice' and 'access to legal services'. We take 'access to justice' to refer to the ability of a citizen to pursue a legal remedy or defend themselves against criminal charges or civil claims where, on any reasonable view, legal representation ought to be available to them (and in some cases even where they would not be otherwise able to afford it). Such representation might be referred to as 'legal services of necessity'. Any denial of that representation could lead to someone being unnecessarily or unjustifiably deprived of assets, outcomes, livelihood, reputation or liberty and, in the public interest, society requires that access to justice should be as broadly and reasonably available as possible.

On the other hand, 'access to legal services' refers to a broader type of access where legal services might be either necessary (in the access to justice sense) or desirable rather than critical. In this broader sense, the wish to access legal services is the result of a choice made by the citizen (such as moving house, making a will, entering into a contract, making tax-driven dispositions of property), and might be referred to as 'legal services of choice'.

[44] Cf. our response to Question 25 below.

There might well be times when access to justice is compromised by an inability to access legal services (for example, where local legal advice is not available). However, the two are not the same: for example, services may be available, but the citizen is denied access to justice by an inability to pay for them.

There may, nevertheless, be an interdependency between access to justice and access to legal services. For example, we consider that the actions of one (probably large or dominant) provider in a particular legal service could compromise the viability or survival of other full-service providers in a location. If those other providers were to go out of business, clients' access to those broader services would be affected and access to justice could be reduced. In particular, we are concerned that if, or as, work migrates from high street law firms to (possibly dominant) new entrants, an element of historical subsidy might disappear from law firms, leaving some services – particularly the more complex and bespoke – perhaps becoming even more expensive. Again, for those clients who are not eligible for legal aid, this might reduce their access to justice.

We agree with the LSB's view expressed in paragraph 7.3 of the Consultation Paper that 'access' is broader than the geographical availability of face-to-face legal advice and representation. Indeed, we regard the meaning of 'access' as crucial to any assessment of the access to justice condition, and to any judgement about whether it is improved or compromised. In addition to geographically, we consider that access should be assessed financially (the wherewithal to access), technologically (virtual and on-demand or as-needed access), logistically (such as the personal or local availability of technology or transport), and intellectually (meaning the understanding and skills to access and take advantage of legal advice and representation).

We therefore believe that access to justice needs to be a principal concern of the LSB and licensing authorities[45]. More particularly, we believe that if the LSB identified those client groups for whom, and the relevant legal services to which, improved access was required, there might be differential targeting of regulatory intervention to achieve more specific access goals. In other words, consistent with the view we expressed in our response to Question 11 above, simply addressing market failures (even as a matter of principle) in the delivery of legal services will not necessarily or inevitably achieve a desirable public outcome such as improved access to justice without better articulation and clarity of public good objectives. We have yet to see this 'better articulation' as part of the LSB's strategy for the legal services market. While we would welcome and support wider and easier access to legal services, we would suggest that access to justice is more important than access to legal services, and there should be no undue haste or risk-taking where there is any suggestion or

[45] There is, of course, the statutory obligation on a licensing authority in section 83(5)(b) of the Legal Services Act to include in its approved licensing rules provision about how it should take into account the regulatory objective of improving access to justice: we note that the requirement is to 'improve' and not 'secure'.

concern that improved access to legal services could compromise, undermine or threaten access to justice.

There seem to be two related, but often confused, issues on the question of access to justice. The first is the basis on which licensing authorities will articulate in their ABS licensing rules how they intend to take account of the 'access to justice' objective. This first issue is important for the reasons discussed above in relation to the potential interdependency between access to justice and access to legal services. To improve access to justice (as required by the Act and, presumably, the terms of a licensing authority's designation as well as its approved licensing rules), regulators could be taking a significant risk with access to justice in simply allowing market forces to determine the provision of legal services. This suggests a need for licensing conditions or subsequent intervention that would – deliberately – interfere with open competition in order to preserve or improve access to justice. This, in turn, reinforces the need for applicants to know in advance the basis on which a licensing authority would decide to attach conditions or to intervene to secure the desired public good outcome (and presumably to see some articulation of what that desired outcome is[46]).

The second issue is the basis on which licensing authorities will assess individual ABS applications in the context of the access to justice objective. Given the variety and variability of particular circumstances, it could be argued that this might best be assessed on an exception basis – that is, by assuming that the application should be granted unless there are concerns, circumstances or objections suggesting that access should be examined by way of, say, an independent market impact assessment (funded by the applicant). We take it that this is the foundation of the LSB's view in paragraphs 7.5 and 7.6 of the Consultation Paper that licensing authorities should be circumspect about jumping to conclusions about the effect of (even very large) ABS applicants on the marketplace, and that the access to justice condition is unlikely to lead to the rejection of applications.

While we have some sympathy with the 'exception-based' approach, we are not ultimately persuaded by it. Although there might be a strong case to suggest – as the LSB does in paragraph 7.7 – that "competition will drive innovation in all parts of the market and enhance access to justice", using this as a basis for an 'exception-based' approach would be to privilege the 'market failure' policy. In our view, access to justice is a public good that will not be maintained or improved simply by addressing market failures. Our preference, therefore, would be for licensing authorities to start from an 'open' position that neither assumes (as the exception-based approach would) that access to justice will be maintained or improved unless a need to investigate suggests otherwise, nor prejudges that access to justice is likely to be compromised and must be proved to the contrary by an applicant.

[46] This would be an example of defining a welfare benefit or public good that justifies intervention: cf. our response to Question 11 above.

We consider that access to justice must be examined as part of the determination of a licensing application – just as we believe that no short cuts should be taken in the assessment of whether someone is a 'fit and proper person' to be a HoLP, HoFA or non-lawyer manager of an ABS. It is possible that, by confining consideration of the access to justice condition only to the 'micro' level of individual applications, regulators might not notice over time the cumulative 'macro' effect of structural changes in the market and to access to justice until it is too late to reverse the adverse effects[47]. This suggests to us that the LSB and licensing authorities should review on a regular basis (probably annually) the state of the overall market, and the Board should expressly include within its annual report under section 6 of the Legal Services Act an assessment of the effects on access to justice of developments generally and of ABS licences particularly.

The Institute also wishes to express some reservations in relation to the comments in paragraph 7.8 of the Consultation Paper. The current reforms which, rightly in so many respects, encourage more providers of legal services to adopt good commercial structures and practices in their delivery of legal services, inevitably push lawyers and law firms further towards an economic paradigm rather than a professional one. There is, in our view, a significant risk (in parallel with a trend that we have already seen with so many law firms withdrawing from their commitment to legal aid provision) that *pro bono* work will be seen as an attribute, and part of the responsibility, of being 'a professional' rather than of being in business. Far from new market entrants adopting the hallmarks of professional practice and pursuing *pro bono* work, we think it equally likely that law firms will reduce or eliminate *pro bono* support in the pursuit of more overtly economic aims and competitive efficiency (except, perhaps, as part of a broader remit of corporate social responsibility). Unless the regulators wish to consider imposing a condition on regulated entities to undertake some level of *pro bono* provision – rather like the imposition of social housing conditions on planning applications – we might well see an overall decline in the availability of *pro bono* services to the public, with some potential deterioration in access to justice for some vulnerable segments of society.

Finally, there is a further, more disturbing issue in relation to access to justice. A consequence of the 'regulatory gap' that is identified in our responses to Questions 20 above and 25 below is that the sort of intervention that will be possible on access to justice grounds in relation to ABS applicants or licensees who deliver reserved legal activities will not be available to curb the actions of those unregulated entities that deliver only non-reserved activities in such a way that they drive existing (full-service) regulated providers out of the market.

[47] It follows that the Institute is not inclined to accept the LSB's contention in paragraph 7.6 of the Consultation Paper that it is likely "to be difficult to conclude that an application from a single licensable body – even a very large retail brand for instance – would reduce access to justice for consumers as a whole".

Question 22. How should licensing authorities give effect to indemnification and compensation arrangements for ABS?

We raised some risk issues in our response to Question 12 above which point to a need to focus on indemnity and compensation arrangements, as well as raise the concept of 'capital adequacy'.

While the licensing framework is drawn in such a way that capital adequacy could certainly be considered as a precondition of issuing or retaining a licence, we agree with the LSB that a licensing authority would need to be careful not to create unnecessary or unreasonable barriers to entry, and to ensure that it had the ability to assess and monitor such adequacy.

There will be a number of circumstances in which, potentially, capital inadequacy might arise:

(1) inadequate initial funding of the business for the risks undertaken or to meet fixed and working capital requirements;

(2) change in economic conditions generally (e.g., recession) or increased risk to the business (e.g., work taken on or lost); and

(3) withdrawal of capital by owners or investors: this might be deliberate (e.g., where an ABS is perceived to be underperforming) or inadvertent (e.g., where owners withdraw too much money for their own other business or personal requirements, leaving the ABS under-funded).

Arguably, these circumstances are not unique to ABSs. However, we are concerned that the potential scale of new entrants or investment could well result in increased risk.

For a licensing authority to be aware of capital inadequacy or other risks of financial failure, however, also presupposes that there should be an obligation on an ABS to disclose that inadequacy or risk. This could perhaps be achieved by requiring the HoFA to notify the licensing authority if, say, the ABS was in breach of its banking covenants. However, there is a strong argument to be made that such issues are not in fact specific to ABSs but are a feature of all businesses. We agree with the statement in paragraph 7.16 of the Consultation Paper that "the job of the regulator is to ensure protection for client interest and money, not to preserve the solvency of the firm". That is why we believe that a licensing authority's interest must focus on market stability, access to justice and client protection: these are legitimate public interest concerns.

On balance, informed dialogue with banks and investors might represent a more realistic way of securing financial stability and prudence within legal services providers than regulatory notification and intervention. Our view is therefore that capital adequacy could well be a reasonable focus of attention for a licensing

authority considering granting an ABS licence with conditions attached where the application is based on objectives or in circumstances that suggest high(er) risk, or where monitoring of the ABS suggests that changes in business circumstances, ownership, complaints profile, or funding exposes the ABS to increased risk (cf. our responses to Questions 12 and 19 above).

Question 23. How should complaints-handling in relation to legal services provided by ABS be regulated?

We would draw a distinction between the formal *structure* for complaints handling and the *attitude* within regulated entities when dealing with complaints. We agree with the LSB that there should not in principle be any different approach to the structure within ABSs for handling complaints. This should therefore mean that the complaints structures and regulations of an approved regulator should be capable of being applied by the corresponding licensing authority. As a consequence of an ABS being licensed as an entity, there will need to be arrangements in place for the appropriate referral to the regulator of any individual of complaints and disciplinary issues arising in relation to professionals or staff involved. We do not, however, see this as causing any great regulatory or logistical challenges.

Where the Institute would wish to see significant change, however, is in the response of law firms to complaints made and their disposition. We believe that there is much to learn from the experience and philosophy of retailers (and which we hope some of the new entrants will bring into the legal services marketplace). Rather than regard a complaint as a challenge to professional integrity, to be resisted and fought pretty much at all costs, we would prefer to see complaints handled very quickly and with a view to resolution, rather than as a protracted exercise in determining the underlying veracity of the complaint and the correct attribution of blame. Where there is no question of liability for professional negligence, we can see no merit in complaints handling which results in significant opportunity costs for the firm, additional cost and delay for the client and, where there is no immediate or mutually acceptable resolution, additional cost to the legal services market through the need to staff and operate the Office for Legal Complaints at a higher level than might otherwise be necessary.

Question 24. How should licensing authorities approach the 'fit to own' test and how critical is it in mitigating the risk to the regulatory objective of promoting lawyers' adherence to their professional principles?

When considering whether non-lawyers could be regarded as appropriate owners of a law firm, the Clementi Report (*Review of the Regulatory Framework for Legal Services*

in England and Wales, Final Report 2004, Chapter F, para 40) adopted a 'fitness to own' test that would have had regard to an applicant's:

(a) honesty, integrity and reputation;

(b) competence and capability; and

(c) financial soundness.

Although the Department for Constitutional Affairs indicated that these same criteria would be part of the legislative fitness-to-own test[48], only the factors in (a) and (c) would seem to have been explicitly included in the Legal Services Act (Sch. 13, para 6). Consequently, competence and capability would only be considered if licensing rules specifically so required – unless, presumably, there was evidence of an applicant's incompetence or lack of capability that was judged to compromise the regulatory objectives, compliance with professional standards or regulations, or otherwise be so gross as to make the applicant manifestly not a fit and proper person. In other words, in the absence of express provision in licensing rules, competence and capability become, negatively, matters relevant to withholding approval rather than, positively, conditions for granting approval. This seems to us to be a retreat from the positions expressed in the Clementi Review and the DCA's White Paper.

The Institute believes that the fitness-to-own test will be a key component in the credibility and success of ABSs. In its response to the SRA Consultation Paper on character and suitability for non-lawyer managers in LDPs, the Institute submitted:

> In our view, the new legislative framework provides an opportunity to define what 'managers' need to be able to do, and then to apply that definition, on an entity basis, to all recognised bodies and to all 'managers'. This would be preferable to persisting with the failure to distinguish between the competence and suitability of those who should be authorised to deliver legal services and the competence and suitability of those who should be approved to own and manage the entities through which those services are delivered.

In relation to the character and suitability test for LDPs, the Recognised Bodies Regulations 2009 allow the SRA, when deciding to refuse an application for initial recognition, to take into account that it "is not satisfied that the managers of the applicant body, taken together, have sufficient skills and knowledge to run and manage a business which provides regulated legal services" (Regulation 2.3(d)). Although there is therefore no test of competence or capability for individual managers, and the framework does not go as far as the Institute might ideally wish[49], these Regulations do, at least, meet the Institute's concern that the overall assessment of management capability should be applied to all managers, whether

[48] See *The Future of Legal Services: Putting Consumers First* (2005), para 6.6.

[49] See further our reference to the FSA position on competence for those with 'significant influence functions' in our response to Question 18 above.

they are lawyers or not. We believe that the same approach should be adopted, as a minimum, in relation to ABSs.

We make the following additional observations:

(a) There are other activities that require some tests of competence before businesses are allowed to operate (including, for instance, financial services, airlines and gaming).

(b) Qualification as a lawyer does not involve any necessary competence in ownership.

(c) There should be parity of treatment on the issue of competence and capability as between lawyers and non-lawyers so that, if there is no test of competence or capability as a precursor to ownership by lawyers, there should not be one for non-lawyers.

(d) In reality, we accept that it might be very difficult to devise an adequate test of ownership, and that the best approach in relation to individuals is to take account of their probity and integrity. In this sense, there should be a clear distinction between ownership and management. While it might be difficult to assess competence to own, management competence and capability could be tested in relation to the statutory positions of Head of Legal Practice and Head of Finance & Administration (see further, our response to Question 18 above).

(e) There is therefore a strong case to be made that ownership competence should not be a regulatory issue – except, perhaps, where non-lawyers are in a majority of ownership and control (echoing Sir David Clementi's comment recorded in our response to Question 17 above about ensuring the 'ethical competence' of the business). On this view, a licensing authority should concern itself with a firm's ownership and governance arrangements, and whether its structure, staffing and resourcing are such as to suggest any risk to ownership or management competence. Such issues might also influence the support to firms offered by banks or other investors through funding and by insurance companies through professional indemnity cover.

In summary, we believe that competence should be an issue that is positively assessed and approved in relation to the positions of HoLP and HoFA (and possibly to an individual who holds ownership or voting control), but not generally in relation to the interests of 'managers' (as statutorily defined). This will focus attention in the fit-to-own assessment of most managers on the issues of probity and integrity, financial position, and associates.

The Institute does not expect that the fitness-to-own test will represent a complete safeguard to lawyers in an ABS not being subject to undue pressure from over-

zealous owners to compromise their professional principles. Some reliance will need to be placed on a licensing authority's process and procedures for requiring full disclosure of the identity of the ultimate beneficial ownership of interests in ABSs. The integrity of the HoLP and HoFA must also play a key role (which is another reason why we set more store by some assessment of competence for these roles). We also expressed approval in our response to Question 11 above for the idea of a statement of a 'hierarchy of duties', and we would favour owners (whether lawyers or not) being expressly required to subscribe to this hierarchy.

Question 25. Are there any particular risks to the regulatory objectives that could arise from ABS offering non-reserved legal services?

The Institute does not consider that any particular risks arise from ABSs offering non-reserved services. However, as we said in our response to Question 20 above, we would be concerned about the lack of a level playing field (1) if ABSs were allowed to hive off their non-reserved activities in ways that regulated law firms cannot, and (2) where ABSs and regulated law firms are at a competitive disadvantage as against unregulated entities delivering non-reserved services.

We recognise that the Legal Services Act's 'regulatory gap' preserves a situation that has prevailed for many years, namely, that a non-lawyer-owned provider delivering non-reserved activities will not need (or be able) to be licensed or regulated under the Act. Non-lawyer-owned providers delivering reserved activities (whether or not alongside non-reserved activities) must be licensed and regulated as ABSs, and lawyer-owned firms delivering non-reserved activities (whether or not alongside reserved activities) will be recognised and regulated by the SRA or other approved regulator.

It seems to the Institute that the commercialisation of law and the emphasis on consumerism that will arise from the implementation of the Act and the LSB's work will raise the profile of legal services, perhaps creating additional demand and offering encouragement to providers. Indeed, the LSB has a statutory obligation to promote competition in the provision of reserved legal activities and in non-reserved activities of the sort provided by lawyers (ss. 1(1)(e) and (2) and 3(2)). But it is then given powers only over approved regulators and licensing authorities (which in turn apply their powers to authorised persons) or in its own capacity as an approved regulator or licensing authority (similarly only over authorised persons). While the complaints ombudsman scheme will apply to non-reserved activities, the respondent must nevertheless be an authorised person (s. 128(1)).

From the point of view of protecting the interests of consumers (s. 1(d)), there appears to the Institute to be a significant shortcoming in the legislation: their protection in relation to the purchase of what they perceive to be a 'legal service'

(such as the drawing up of a will) varies depending not on the product or service purchased (a will) but by the nature of the provider (an authorised person providing a non-reserved activity, or a non-authorised person providing an activity for which no authorisation is required). We are also concerned that (if allowed) the ability of larger providers to separate their delivery of reserved and non-reserved activities into different legal entities which nevertheless still share some common brand identity could be confusing to consumers. The replacement of a 'lawyer' approach to regulation with an 'entity' approach still leaves a fault line in relation to non-reserved services or products provided neither by a regulated lawyer nor a regulated entity.

There is undoubtedly some force in the consumer view that supports comparability of treatment in relation to any given 'legal service' experienced by a client – even in a new regulatory framework based in part on not extending professional monopolies. It is the Institute's view that in both the public and consumer interest an early review of non-reserved activities should be undertaken. We fully appreciate that any review will have to address a cost-benefit analysis of extending regulation through reserved activities as against allowing the current 'mischief' to continue. However, we think it right that an informed public debate of the issues for and against extending regulation should be conducted at an early opportunity.

Question 26. What are the risks to the consumer associated with the delivery of legal services by special bodies and which more general risks are less relevant to these bodies?

As with the issue of the authority to regulate the non-reserved activities of non-authorised persons (cf. our response to Question 25 above), the absence of a service or product approach to regulation could potentially leave consumers facing different approaches to regulation and redress depending on whether they have sought advice from 'fully' regulated law firms or ABSs, differently regulated special or low-risk ABSs, or unregulated providers of non-reserved activities. We have no wish to see one 'regulatory maze' replacing another.

It seems to us that the risks associated with poor advice or service resulting in complaints or disciplinary action, and the handling of clients' money, remain as real with special bodies as they do with law firms and full ABSs. While it may be true that the risks of conflicts of interest arising from commercial pressure are reduced or eliminated in the case of special bodies, we do not regard the absence of conflicts as a hallmark of these special bodies. Indeed, we can foresee that funding pressures, and career motivation, can play as much a role in their potential to distort ethical behaviour and compliance with the professional principles as they can in any other environment. We therefore believe that the core obligations relating to ethics, complaints handling, and client accounts should apply to special bodies. Further,

given the potential for non-lawyers failing to understand or appreciate the statutory and professional duties associated with special bodies with an ABS licence, the express articulation of a 'hierarchy of duties' (discussed in response to Questions 11 and 24 above) would also be worth considering in this context.

Question 27. Is it in the consumer interest to require special bodies to seek a licence, and if so, what broad approach should licensing authorities take to their regulation?

To secure the protection for clients that we believe is necessary (based on our response to Question 26 above), the Institute supports the application of entity regulation to special bodies. We therefore favour the principle of ABS licences for these entities. We believe that the Consultation Paper correctly identifies the relevant issues. We would also support the concept of group licences where licensing authorities are satisfied that this is an appropriate response.

While the Act offers the prospect of special bodies not requiring a HoLP or HoFA, in our view the roles are of such critical importance in maintaining professional standards, quality of service and client protection that we believe they should be required for all licensed bodies[50] (with the exception of trade unions[51]). We also believe that the HoLP and HoFA should be appointed to sit on the governing body of the licensed entity to ensure that decisions are consistent with the regulatory objectives, the professional principles and the terms of the entity's ABS rules and licence.

Where the approach to entity regulation is based on similar principles, irrespective of whether the entity is a regulated law firm or a licensed body, we consider that meeting the needs of the public interest, consumer protection, and parity of treatment will be met. The Institute therefore believes that the low-risk nature of special bodies should be reflected, not so much in the licensing structure, but rather in the reduced time that would be needed for disclosure and approval of the non-lawyer involvement and in the perceived lower need for monitoring, as compared to ABSs with greater non-lawyer control and higher-risk objectives.

4. Confidentiality

We do not wish our views to be confidential and have no objection to our responses being attributed.

[50] Indeed, we can see great merit in all regulated entities that provide legal services – whether reguialted law firms, LDPs or ABSs – being required or encouraged to make such appointments.

[51] Only because trade unions which become licensed bodies cannot be required to have a HoLP or HoFA: s. 105(1).

The Legal Services Policy Institute

The Legal Services Policy Institute (LSPI) was established by the College of Law in November 2006. Its principal objectives are to:

(a) seek a more efficient and competitive marketplace for legal services, which properly balances the interests of clients, providers, and the public;

(b) contribute to the process of policy formation, and to influence the important policy issues, in the legal services sector and, in doing so, to serve the market and public interest rather than any particular party or sectional interest;

(c) alert government, regulators, professional bodies, practitioners and other providers, and the wider public, to the implications of these issues; and

(d) encourage and enable better-informed planning in legal services by law firms and other providers, government, regulators and representative bodies.

The Institute seeks to form and convey independent views; where the College might have views as a provider of education, these are expressed separately.

The Director of the Institute is Professor Stephen Mayson, who can be contacted at:

Legal Services Policy Institute
The College of Law
Gavrelle House
2 Bunhill Row
London EC1Y 8HQ

Tel: +44 1483 216393
E-mail: Stephen.Mayson@lawcol.co.uk

Web: www.college-of-law.co.uk/about-the-college/legal-services-policy-institute.html