Referral Fees LSB Consultation – A Response

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I have read the Board's consultation paper and associated documents, including those from the Consumer Panel and the associated research from Vanilla and Charles River Associates (CRA) with interest. Although, as will be apparent, I have doubts about the evidence base on which the LSB is currently relying, I applaud the LSB's endeavours in seeking to adopt a more evidence-based approach to policy making than has hitherto been taken in the area and in focusing on the wide-range of interests which the Legal Services Act requires the Board to bear in mind. I also recognise that the regulatory issues posed by referral fees are both difficult and emblematic of central tensions likely to be tested further by competition and innovation in delivery and ownership of legal service entities. With that in mind, and recognising that we should locate referral fees in a wider context, I would like to see a stronger and more direct focus on quality in any regulatory regime for referral fees and make some suggestions in that regard towards the end of this response.

Do I agree with your analysis and evidence (qq. 1-5)

Broadly. I accept the point that banning (and perhaps regulation of) referral fees can be avoided by a number of techniques and that, as legal service markets develop in sophistication and complexity, there will be significant difficulties posed by singling out referral fees as a commercial relationship deserving unique attention. I also accept the point that 'banning' referral fees is likely to be disproportionate in most, possibly all, areas of work. Similarly, referral fees may sometimes bring benefits to consumers by encouraging efficiency and price reduction and that inhibiting them may stifle some of the innovations in delivery and intermediation developing at the moment.

Equally, however, I would emphasise the real risk that referral fees can lead to detriment in terms of quality. This is a point made nicely (and then equally nicely undermined) in the CRA report (page 99):

> "Some interviewees who have expressed concerns about the role of referral fees have suggested that increases in referral fees lead to a reduction in the quality of legal services because lawyers retain less fees to conduct the work. As such it is argued that they will spend less time on any given case and quality will fail.
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> "It is noted that a potential reduction in the quality of service is only possible because customers are not able to assess the quality of services that lawyers are providing on their behalf. The quality of legal services relies on the professionalism of solicitors with or without referral fees. If lawyers are able to provide low quality services because customers cannot judge this, then lawyers will be able to do this, indeed have the incentive to do this, with or without referral fees."

However, what the points made do not acknowledge is the possibility that referral fees, in squeezing down on the profitability of work for solicitors (or other legal service providers), may *increase* the incentive towards lower quality referred to in the second paragraph. Research on, for example, fixed fees in Scotland would suggest that diminution in quality associated with restricted cost can be real (although a debate might also be had as to whether it might also be more efficient). For me this

implies that quality is both a general problem (possibly not adequately regulated at the moment) but also a problem likely to be accentuated by referral fees. If referral fees are to be regulated, that regulation might sensibly concentrate on incentivising quality rather than (say) disclosure to clients.

Much of the evidence base that the report builds upon on the crucial issue of quality is weak. This is particularly so in relation to criminal defence but also, in my opinion, in relation to the conveyancing data.

In relation to the conveyancing data, for example:

- Claims that referral fees lead to speedier conveyances, lower fees and fewer complaints are wholly or mainly based on a small survey of Estate Agents conducted by an intermediary on behalf of CRA. Those completing the survey largely had an interest in the survey saying referral fees were beneficial and so it proved. In my view minimal weight should be placed on such evidence.
- I struggle to see how claims that levels of satisfaction are higher under referrals are evidenced in the studies referred to. In any event my own client satisfaction work (with Sherr and Paterson and also for BIS more recently on tribunal claims) suggests that clients who are referred regard that referral as a recommendation and are more likely – as a result – to perceive the quality of the work as being higher (i.e. the likelihood is that the referral itself has some impact on *perceptions* of quality).
- I would be doubtful about putting much if any weight on 'non' findings[1] such as the claim that there was no evidence of problems with title caused by referrals. Unless we can be reasonably confident that title problems were investigated with some thoroughness, this tells us little.

I think these criticisms are generally less true for the personal injury data. It seems to me fairer to say in this area that there is less evidence of detriment. I would not, however, agree that reliance should be placed on the 'non' finding of no evidence of cost having increased: there is actually very little data on costs in the report. I have some reservations too about the data on settlement levels (my own analysis of CRU data suggests that cases generally are getting smaller which rather contradicts the DataMonitor data on settlement level, but I do not have access to that data to check and compare).

The general absence of data on benefits and detriments is particularly interesting in the context of criminal defence. There is some evidence of detriment, although it is based on a small number of interviews and evidence from, in particular, the Bar. A causal link between detriment and referral is not firmly established but is plausible. Similarly, as the report correctly points out, such detriment is not quantified. Furthermore, one can see the point that:

- Some fee sharing is required for flexibility (to deal with last minute non-availability issues for instance).

[1] By non-findings I mean a finding that there has been no evidence to support a proposition. The implication being that the proposition is either not true or not sufficiently supported to require regulatory intervention. I can understand why the latter type of finding is useful to the regulator's decision-making process but an important issue is to what extent a regulator (be that the LSB or (say) the SRA or BSB) should investigate an issue before satisfying itself that there was no evidence in support.

- The relationship between barristers and their clerks relies on a fee sharing agreement (either in form or in substance) with some of the same risks where clerks choose barristers for solicitors. This is not a practice which appears to have been criticised, and one can see how this is somewhat less problematic than the problems averted to in the CRA report but is nevertheless problematic (I certainly had experience in practice of clerks suggesting solicitors instruct barristers of doubtful suitability way before graduated fees drove problems with referral arrangements).
- There is the (similarly unquantified) possibility of benefits to be gained by greater competition in relation to advocacy (e.g. price reduction and less duplication of effort between litigators and advocates). Such benefits do not seem to arise within the current pricing structures where competition appears only likely to benefit solicitors (ancillary benefits might be achieved in terms of quality but these are likely to be marginal at the moment and are outweighed by the broader risks). *In the context of the current funding arrangements* the evidence suggests that referral arrangements should not be permitted. Given what I am about to say in relation to future changes to funding arrangements, it may be appropriate for any ban to be maintained by the LSC rather than an overarching ban on referral arrangements by professional regulators. This is because the potential to facilitate future competition and innovation in delivery is an important reason to be borne in mind in weighing detriment and benefit. It should also be borne in mind that the operation of the Bar's protocol on fee sharing appears likely to have inhibited a competitive response to solicitors' approach to fee-sharing arrangements in criminal defence work.
- If there were adequate measurement of quality in the regulatory system, the problems posed by referral arrangements would be detected and ameliorated. The absence of adequate quality assurance/measurement to counter the potential detriment pushes the LSB towards a difficult decision: should a profession's failure to introduce adequate measurement and assurance of quality be a sufficient reason to inhibit potential competition in the future? The trajectory of QAA is still uncertain and the need for it to be robust is essential to the issue of fee arrangements but also to legal aid competition as presaged (again) in the Green Paper. The Bar Council, have in their recent submission with the CBA, indicated a view that QAA will not be robust enough. This is an interesting admission in the context of their opinion that litigators are less and less likely to scrutinise the quality of advocates (the result being that price-neutral referral as a mechanism for promoting quality is significantly weakened whether or not referral arrangements are permitted). Furthermore, if the Bar Council are right – firms are no longer generally able to monitor advocates in court by sitting behind – then such firms need to monitor referrals in some way and this would incur some cost. Referral arrangements would be one way of meeting that monitoring problem (notwithstanding the problems that they might also create). This, and the advent of ABSs, mean that the issues extend beyond referral fees and suggest that it might be wrong to isolate lawyer to lawyer referrals as improper. It also re-emphasises the importance of being able to evidence quality in post-Legal Service Act markets.

In summary, in criminal defence in particular, my view is that the arguments and evidence of detriment in particular are stronger than any argument or evidence that referral fees benefit the public under the current system of funding. That still leaves the arguments as to whether

banning can work in practice or is a proportionate response. I have addressed these above but, in essence, a ban can only (at best) be partially successful and will distort emerging competition for legal services. A ban should only be attempted where there is a significant risk of significant harm (in my view this does not *require* evidence of harm depending on the nature and kind of risk but of course evidence is preferable). There is evidence of harm but not how serious that harm is. A ban would inhibit future benefits under different funding arrangements (e.g. competition rather than graduated fees) which might accrue if referral fees were permitted, though the nature and extent of such benefits are uncertain. On balance, and with significant misgivings, this pushes me towards accepting that referral fees should not be banned between lawyers in criminal defence work but that much hangs on the robustness of quality checks, QAA in particular. If QAA cannot significantly ameliorate any risks of serious harm then the value of QAA must be in doubt.

Disclosure, metrics and other issues (qq 6-12)

There is a reasonably substantial evidence base that consumer-facing disclosure requirements have minimal impact either on consumer understanding or on consumer behaviour. My own research on lawyers advice on their fees (the 'Something for Nothing' Report) tends to suggest that when solicitors advise on their own fees a significant number do not follow their own ethical rules, or they do so advise and clients forget or do not understand that advice. As you know, the SRA's work on referral fees suggests similar levels of non-compliance with referral fee regulation. The FSA also found similar problems with investment advisers.[2] A typical response to such concerns (beyond querying whether such research *definitely* proves non-compliance) is that regulation can *improve* transparency: make the information more comprehensive, or more intelligible, more useful, more informative.

The research base suggests, however, that a regulation through information approach will fail. A significant body of work commissioned by the FSA into its reforms of investment advisers suggested that the evidence did not support the hope that better information would reduce conflicts of interest, increase competition, promote consumer empowerment/shopping around and get consumers understand the cost of advice they incur (via commissions).[3] Even where information improved understanding, that understanding was limited[4] and did not influence behaviour. This was in spite of research suggesting consumers would react warmly to information and the information being subject to detailed testing before hand.[5]

Why does such failure occur? Problems of non-compliance by professional advisers (complexity of the information requirements may be a factor, as may the problem that such requirements – if carried out in good faith – may run counter to the adviser's own interests). The information is probably too complex for many clients to understand and act upon (see my 'Something for Nothing' report). For example, some Unions pitch their literature at the reading age of an 11 or 12 year old. Clients' psychological predispositions may also inhibit them from acting on the information they receive. Thus behavioural psychologists point to:[6]

> **"**…a collection of deep seated cognitive biases that influence decisions in both financial and non-financial contexts. These biases include, "procrastination, regret and loss aversion, mental accounting, status quo bias and information overload."

[2] TNS (2006) *Depolarisation disclosure – mystery shopping results* (London: FSA). 130 face-to-face mystery shopper assessments with a range of advisers across the UK mainland. In only 55 cases (42%) were the potential customers given the Menu and the **Initial disclosure document (IDD)** at the correct point in the interview.

[3] See, Darren Butterworth, Kyla Malcolm, Mark Tilden and Tim Wilsdon (2007) 'An Empirical Investigation into the Effects of the Menu' (London: FSA); GfK (2008) Depolarisation Disclosure 2 (London: FSA).

[4] BRMB (2008) Services and costs disclosure, **Qualitative research – mock sales testing (London: FSA).**

[5] IFF Research Ltd and NOP Research Group *(2004) Polarisation – menu testing research* Research prepared for the Financial Services Authority, FSA (London: FSA))

[6] David de Meza, Bernd Irlenbusch, Diane Reyniers **(2008)** *Financial Capability: A Behavioural Economics Perspective* (London: FSA). The quotes are taken from pages 3 and 4.

So, to give one example, procrastination bias may lead to clients discounting a future cost (if they agree to pay something later – in effect what they are agreeing to when permitting a referral - they are less vigilant about that cost than if they are asked to pay it straight away).

> "Many behavioural economists take the view that the best response [to procrastination biases] is not informing consumers of the problem or trying to change them but institutional design and regulation that recognises the psychology."

It follows that a well-motivated desire to increase transparency in relation to lawyer's may have minimal beneficial impact on consumers, whilst increasing the transaction costs of advice providers.

One solution would be to regulate-out unnecessary complexities in referral fees so that consumers could understand the costs which they were about to incur and take decisions with some greater likelihood of their own interest. Making sure a referrer indicated the amount of money changing hands under any referral arrangement would give the consumer a clear and honest signal on referral cost (although unless forced to provide a notional price, referral rewarded through provision of services in kind would evade this and such an approach might militate against service providers who provide referral and some service for their fee). It would however act as some restraint on escalating referral fees and those providing a service would presumably be able to explain this to consumers who could then (sometimes) on whether the services merited the fee. Even if such arrangements could be made to work, I am not persuaded that consumers saying they would like to have better information mean it is likely that regulating to increase client-disclosure will increase confidence in the system.

My view, therefore, is that ARs and the LSB should place minimal emphasis on disclosure provisions targeted at consumers. In particular, it seems to me misguided to require the *recipient* of referrals to give disclosure after the referral. Unless this is likely to add significantly to consumer understanding then a requirement that recipients only take referrals from those who provide necessary disclosure would be sufficient in this regard. Recipients might be required to insist on this by way of contract. Where disclosure is required it might, however, be sensible to require that the referrer is required to disclose the fee changing hands between recipient and referrer. Even this, though, leaves me with doubts on efficacy grounds.

Market-facing disclosure is a more interesting and potentially useful approach. There is the potential for transparency about the actual agreements to have an impact independent of what consumers think or do. Transparency has the potential to open up this murky area to far greater scrutiny by regulators and others. The regulators would have more information, as might some journalists and researchers and other interested stakeholders. Insurance companies would take an interest. Legal service competitors would take an interest. Consumer bodies might also. Enforcement of poor practice might be easier (behaviour that diverged from the contract they had lodged might be evidence of potential detriment to the client or public interest). The debate about the ethics and public interest in relation to these agreements is likely to become more informed and regulators views of the risks better. Nor do I see substantial costs being necessarily incurred by (say) electronic lodgement and publication.

I would also submit that there is benefit in collecting, collating and publishing key data on referrals such as price (recognising the difficulties posed by in-kind services and the risk of evading disclosure ARs and/or the LSB has a significant interest in monitoring the level and trajectory of prices) and

patterns of referral. Over concentration of receipt or the giving of referrals may indicate risk which the regulators should investigate further.

Beyond that, I would emphasise a belief that there is a need to develop better data and understandings on quality and the potential impacts on quality of referral schemes. The evidence base collected by CRA and Vanilla for the LSB and LSCP is better than existed before but it is still weak. No doubt this is largely a matter of resources: a matter to which I hope the LSB and the professions devote more thought.

The need for robust measures of quality is part of the broader needs of the system. To my mind it is questionable whether client-service and market driven quality standards will be sufficient to withstand severe competitive pressures generally or specifically from referral fees. Client-driven standards may improve service quality but there is a risk that competition will drive out less easy to monitor technical quality. Monitoring referral agreements and patterns of referral could only be a very crude signal that a risk was developing. Actual assessments of quality would be needed to demonstrate manifest harm: though given cost and proportionality concerns one would expect such assessments to be strongly influenced by judgment on risk.

A key part of the approach should be to incentivise quality through the referral arrangement. One approach would be to require referrers to lodge, with their agreements, their approaches to ensuring that referrals are made in the clients' interests, as opposed to on purely commercial grounds. This might include, but one would hope develop beyond, service level agreements. It is notable that the service level agreement approaches found so far are pretty minimal (even if they may have lead to some improvement in service standards) and that over time, in the light of broader identification of risks, these might develop into stronger systems of quality assurance and measurement (particularly amongst the major referrers). It could also be a requirement that regulated providers secure contractual rights for themselves and regulators to have access to and the ability to audit the systems of those providing referrals. That is not to suggest that such powers should be used routinely but to provide a legal mechanisms through which adequate regulation could be secured should risks of detriment become apparent.

More broadly it will be important for ARs and the LSB to develop better metrics for the overall quality of work done in the system (some of which might be performance indicators which referrers or regulators might monitor more closely and some which would be system-wide). It is to be hoped that these look beyond client satisfaction (which should be fairly well catered for in the operation of a market anyway) towards more meaningful outputs such as objective data on (for example) title failure; levels nature and outcome of claims and so on. In relation to criminal justice, it should be possible, in theory and one would hope in practice, to develop metrics tracking outputs in the criminal justice system (pleas, acquittals, swapping of advocates), QAA data and legal aid data which might with a reasonable degree of sophistication provide some view on whether the defence system as a whole was operating more or less effectively. Such data might signal and target judgements to be made on risk and regulation.

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