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Mahtab Grant
Legal Services Board
7th Floor, Victoria House
Southampton Row
London WC1B 4AD

By e-mail only

Alternative business structures: approaches to licensing

We welcome the opportunity to respond to your consultation paper: *Alternative business structures: approaches to licensing*.

Our interest is primarily as one of the leading professional negligence practices in the country. We represent the interests of over 20 different professional indemnity insurers across the broadest possible range of professional liability.

We have responded to the matters raised in the consultation paper from the perspective of the professional indemnity issues that it raises. We have therefore not answered questions which we believe are likely to be of less significance for professional indemnity insurers.

As a general observation, we believe that it is very important that professional indemnity issues are not considered in isolation – this includes considering the potential professional indemnity issues in other areas such as ownership tests and licensing. The insurability of a firm is about more than just the terms of the insurance itself, and in particular, any concerns about the fitness of those controlling the business would be likely to have an adverse impact on its insurability.

If you wish to discuss any of our comments in any more detail, we should be delighted to assist.

Yours sincerely

Mathew Rutter
Partner
for Beachcroft LLP

Beachcroft LLP
100 Fetter Lane London EC4A 1BN UK
dir tel: +44 (0) 20 7894 6322 tel: +44 (0) 20 7242 1011 fax: +44 (0) 20 7831 6630 dir fax: +44 (0) 20 7894 6758
email: mrutter@beachcroft.com DX 45 London

1. What is your view of basing the regulation of ABS on outcomes?

We agree with the broad approach of the Legal Services Board, of setting outcomes for LAs to follow rather than taking a prescriptive approach to regulation. However, it should be down to each LA to determine how they achieve these outcomes; in some areas, detailed rules may be appropriate.

The consultation paper in places seems to blur the lines between principles-based regulation and outcomes-based regulation[1]; we see the two as being rather different. Outcomes-based (or focused) regulation, as articulated, for example, by the Financial Services Authority (**FSA**), is about ensuring that the right outcomes are achieved, by whatever means is deemed appropriate. Although it is not necessarily about rules, rules may in certain areas be the best way of achieving the desired outcome. So while outcomes-based regulation allows the regulator to look beyond the rule book, it should not replace the rule book entirely.

While this is acknowledged in paragraph 54 of the consultation paper, no examples are given of areas where rules may be thought necessary. Areas where we feel high-level outcomes may need to be backed up by detailed rules include professional indemnity arrangements, and obligations relating to the protection of client money. In the latter case, there are certain measures which, as a matter of law, must be taken to ensure protection of client money. There is no scope for negotiating a different approach.

We agree that there is a balance to be struck, given the key objective of the Legal Services Act of ensuring a level playing field between different forms of legal practice, between allowing a degree of competition between regulators, while preventing that competition pushing down regulatory standards or allowing for regulatory arbitrage. We have concerns that achieving this balance may be harder using an outcomes-based approach in an environment where there will potentially be multiple regulators each interpreting the outcomes in a different way. This is not a challenge faced by other regulators which follow an outcomes-based approach to regulation, such as the FSA.

a. Should all LAs have the same core outcomes?

In principle, we would expect all LAs to have the same core outcomes, unless some are clearly inappropriate. Where more detailed rules or requirements are necessary, the same core obligations should apply for all LAs to which they are relevant.

b. Are the proposed outcomes appropriate?

Given the very high level at which the outcomes operate, we have no particular concerns with the outcomes themselves. Our concerns centre more around how they would be given effect to in practice. For example, the consultation paper stresses the importance of consistency between LAs (for example, paragraph 55), but it is not clear to us how regulatory arbitrage will be avoided by means of such high level outcomes which lend themselves to a wide range of interpretations and applications. The implication in the consultation paper that a common set of outcomes will automatically lead to consistency

[1] For example, paragraph 52 includes the statement that "Rather than a detailed set of rules that need to account for every possible permutation of adverse behaviour, principles allow the outcome to be clearly articulated."

of outcomes for consumers, irrespective of the form of legal practice they use. It is not clear to us that the one necessarily follows from the other.

We find the statement at the end of paragraph 56, that it would not be appropriate for LAs to simply replicate their current approach to regulation, rather surprising. If the current regime of a particular LA is effective, and is consistent with the outcomes-based approach proposed by the LSB, why should the LA change its current approach? It is surely fundamental to the proposed outcomes-based approach that LAs should be free to exercise their own judgement in how to give effect to the prescribed outcomes; an LA could legitimately conclude that its current regime is consistent with those outcomes and should be maintained.

c. Is the division between entity and individual regulation appropriate?

We broadly agree with the proposed approach, although as the consultation paper acknowledges, in practice enforcement issues may involve varying degrees of culpability at both individual and entity level.

2. Do you think our approach set out to the tests for external ownership is appropriate?

We would welcome clarification of the statement in paragraph 82 that: "LAs should take the broad approach that generally ABS will make the achievement of the regulatory objectives more likely." We find it strange that LAs should be expected to have a preconceived approach to a particular type of applicant. We would have thought that LAs should start from an entirely "entity-neutral" position, of neither favouring nor disfavouring one particular business structure over another.

a. Should the tests be consistent across all LAs?

We would expect that the tests should be consistent, and consistently applied, across all LAs to reduce the risk of regulatory arbitrage between LAs.

b. Is our suggested approach to the fitness to own test the right one?

We agree with the proposed approach, in particular the proposal for a consistent test for fitness across all LAs. We would strongly encourage the putting in place of arrangements such as MoUs, to facilitate the sharing of information between LAs, and with other regulators.

c. If declarations about criminal convictions are required, should these include spent convictions?

In our opinion, any criminal conviction, but particularly one which points to dishonesty, may be relevant to an LA's consideration of the fitness of a person to own a law firm, even if that conviction is spent.

e. Should there always be a requirement to declare the ultimate beneficial owner of an ABS?

If such a requirement were to be imposed, some flexibility for LAs (so far as this is permitted under the Legal Services Act) would be helpful in cases where, for example, an applicant is a private equity fund. These are often subject to confidentiality agreements which prevent them from disclosing the identity or composition of their investors. This could be problematic if the LA is required to adopt an inflexible approach to approving holders of material interests, even though such investors are invariably passive investors.

f. Overall, are any modifications needed to ensure that our approach work in a listed company?

We assume that the suggestion in paragraphs 73 and 85 relating to amending the constitutional documents of listed companies is intended to operate only where it is the ABS itself which is listed (and subject to the relevant listing rules). The proposal would not be appropriate where the ABS is a subsidiary of the listed company. If the intention is that all shareholders of ABS agree to such a hierarchy of duties in the constitutional documents, this approach could be taken in relation to all ABS, whether or not they, or a parent company, is listed.

h. Do you think that the definition of restricted interest should change?

If we have correctly understood your comments in paragraphs 74 and 108, the only threshold at which an interest in a licensable body would be required to be approved would be 10%. We believe there is merit in considering including an additional, higher threshold (ie a controlled interest), and are surprised that this seems to have been ruled out without consideration of the merits.

An additional controlled interest (being, say, the same as a material interest but with references to 10% replaced by references to 50%), would have certain benefits both for LAs and potential holders of such interests.

If there is a single, 10% threshold, the LA will not have to be notified of any subsequent increase in a restricted interest beyond that which triggers the initial approval, or require that the holder of an increased interest demonstrate that it is fit to hold that larger interest. The danger is therefore that the LA will have to treat a person who holds 10%, with no intention of acquiring any greater interest, in the same way as a person who is seeking to acquire a 100% interest immediately. The alternative, of adding a further hurdle at, say, 50%, would mean that a slightly less onerous process could be put in place at the 10% level. This would reduce the burden on both LAs and applicants, and therefore speed up the process of approval for those seeking a minority interest.

i. Do you think that covenants should be required from those identified as having a significant influence over an ABS?

We are not sure why a covenant should be required from a person with a significant influence over an ABS, but not from persons with other types of material interest.

3. Do you have views on how indemnity and compensation may work for ABS?

We agree that it would be dangerous to regard financial protection – whether in the form of insurance, compensation or otherwise – as a technical or prosaic matter. It is a key part of ensuring that consumers are properly protected when things go wrong.

We have detailed knowledge and experience of the SRA's indemnity insurance arrangements, both under the current arrangements and under the Solicitors Indemnity Fund (**SIF**).

The consultation paper gives the impression, without quite saying so in terms, that it regards the SRA's current open market arrangements, in particular the minimum terms and conditions, as being unduly onerous and an impediment to the introduction of ABSs. We believe that this is to confuse two separate issues.

The first point worth emphasising is that the SRA's current arrangements ensure that, whatever happens, clients will always be protected. There is a price to pay for that, but there are also benefits: most obviously to clients, but also to the reputation of the profession as a whole. The open market arrangements have been a success. There have consistently been twenty or more qualifying insurers operating in the market, and even in the current indemnity period, premiums overall for the compulsory layer are less than they were in the last year of SIF (while providing higher levels of cover). Qualifying insurers have provided high levels of protection to clients at very competitive prices.

There are arguments on both sides of the debate about the merits of having a single renewal date, and the position is not clear-cut; we think that there are more important issues to focus on as a priority.

There is a case for saying that certain elements of these arrangements are proving too costly – most obviously the Assigned Risks Pool. It could also be argued that the profession might be better served by less onerous minimum terms and conditions. However, that is a debate about getting the right balance between client protection on the one hand, versus the cost to the profession and the willingness of insurers to provide that protection on the other. Now is a good time to have that debate but, if the goal is to achieve a level playing field, so that the same level of protection is provided to clients whatever the form of business structure from which they obtain legal services, it is not directly relevant to the specific issues around ABSs.

The consultation paper rightly identifies the fact that there technical issues that will need to be considered by the SRA over matters such as run-off cover being triggered if a firm ceases to be SRA-authorised. That would be a relatively easy issue to address if, for example, all LAs adopted the same set of minimum terms and conditions (whatever form they may take) as one another.

It is important to understand the consequences for clients of the fact that indemnity insurance is written on a claims-made basis. This means that, however carefully a client may check the level of cover provided by a firm at time they instruct them, what actually matters is what protection is in place at the time a claim is made. This could be many years later. If different types of firm can offer different levels of protection, clients will be exposed to changes in the structure of the firm which may occur long after they have

ceased using the services of that firm. The issues referred to in paragraphs 143 and 144 of the consultation paper need to take into account this risk to clients.

The consultation paper suggests that a number of aspects of the SRA's current indemnity insurance arrangements are perhaps not fully understood by the LSB.

For example, paragraph 137 gives a rather contradictory account of how the arrangements deal with any excess. It is entirely a matter for the firm and its qualifying insurer to agree whether, and at what level, any excess should apply. However, since the insurer is required to pay the excess if the firm does not, qualifying insurers will undoubtedly consider whether the firm could (and is likely to) pay any excess that may be agreed. The key point is that, under these arrangements, the consumer is not prejudiced by whatever arrangement may be in place between the insurer and the firm.

Paragraphs 141 and 142 paint a rather confusing picture about the SRA's run-off requirements and successor practice definition without acknowledging the issues that the SRA's arrangements seek to address – or indeed recognising that they do ensure client protection in all cases. These include the practical issues referred to above which stem from the fact that indemnity insurance is written on a claims-made basis.

It is incorrect to state that a firm which "walked away" without buying run-off cover would leave claims to be paid by the compensation fund. In those circumstances (assuming no successor practice), currently the firm's qualifying insurer at the time the firm's practice ceased (or if none, the Assigned Risks Pool) would provide the run-off cover. There would also be likely to be disciplinary issues for the individuals concerned, so it is not going be a particularly attractive option.

The successor practice mechanism is designed precisely to provide a more cost-effective option for firms wishing to cease their practice. It allows the cost of meeting future liabilities to be spread over time and to be offset against the potential future revenue stream associated with the firm that is closing. In many cases, this provides an effective solution. Where it does not work, this may be because of more fundamental issues around the ceasing firm. While it is true that the costs may be higher than they would be if the minimum terms and conditions were less onerous, the solution may equally be to look at the scope of the minimum terms and conditions; it does not necessarily mean that the successor practice model is flawed.

a. How should an appropriate level of PII be set for ABS that are carrying out a variety of different activities, not all of which are currently regulated by the ARs?

We do not feel qualified to comment on what the level of PII should be, or how it should be set. However, we would point out that "the level of PII" is not synonymous with "the level of client protection". For example, under the SRA's current arrangements, there are, in effect, infinite reinstatements to the cover provided. This means that clients know that if they have a valid claim for up to £2 million, there will always be cover in place to meet that claim in full. This is a simple, but powerful message to reassure clients that if things go wrong, protection is in place.

By contrast, a higher level of cover – e.g. £5 million, but with limited or no reinstatements, could mean that the insurance "pot" has been exhausted by the time a particular client comes to make their claim.

We note the very preliminary research referred to in paragraph 138 of the consultation paper. We would agree that more detailed research would be sensible. However, it is worth bearing in mind the fact that the relationship between the level of cover and premium is not linear. For example, when the SRA increased the minimum level of cover a few years ago from £1 million to £2 million, the typical additional premium in return for a doubling of cover was around 10%.

In addition, we would suggest that there are reputational issues for the profession to consider in setting these levels. It should not just be a question of the minimum level of cover that the profession can get away with.

In any event, many practices which obtain top-up cover above that required by the SRA, in some cases running to tens or even hundreds of millions of pounds worth of cover. It would be helpful to provide some information on the level of top-up cover which firms choose to take out, to get a complete picture of the indemnity insurance market.

Another option which may merit consideration is alternative forms of protection other than insurance – for example parental guarantees, letters of credit or capital in the regulated firm itself. We see not reason why the LSB needs to prescribe a requirement for insurance, as opposed to other forms of financial protection, provided those alternatives offer comparable client protection. However, the LA would need to be satisfied that these alternatives came with a mechanism to assess and handle valid claims. They could be used in combination with insurance – for example, a practice might be allowed a higher excess if it carried a high level of capital. Examples of how this might be done can be found in the FSA's indemnity insurance requirements for FSA-authorised firms.

b. Should there be minimum PII levels, which are the same for all LAs for different types of activity?

We think that having different PII levels for different types of business, while superficially attractive, would be difficult to police, would not necessarily result in significant cost savings, and would be confusing to clients.

c. Are Master policy arrangements appropriate for ABS?

We have no strong views on the form of insurance cover, but it might be tricky to harmonise different forms of insurance cover across different forms of legal practice.

d. What would be appropriate arrangements for runoff and successor practices to enable sufficient commercial freedom for ABS as well as protection for consumers after practice closure?

There are only two practical options that we can see which ensure consumer protection after a practice closes – we assume that this is intended to cover a case where a firm moves from one form of structure covered by one LA to another form subject to the regulatory regime of another LA. A reasonable starting point would be to say that the client must have the level of protection that they thought they had when they purchased the legal services from the legal practice in question, for long enough to ensure that at least most claims would be covered, whatever may have happened to the firm since.

That points either to run-off cover being purchased, or to another firm assuming responsibility for insuring those risks.

As noted above, alternative forms of financial protection may also have a role to play here.