Chester & North Wales Law Society's Response

To the consultation paper

“Regulating Alternative Business Structures”

The Chester & North Wales Law Society welcomes the opportunity to be able to respond to Consultation Paper 18 concerning the regulation of alternative business structures.

INTRODUCTION

It is quite clear from the "Clementi" Report that the public interest and consumer interest is of paramount importance. It is therefore important that regulations are developed which:

(a) Put the consumer's interest first.
(b) Avoid conflicts of interest.
(c) Ensure that the consumer is adequately protected from dishonesty and incompetence. A consumer buying a conveyancing service from a high-street store should receive the same ethical standards, consumer and financial protections and minimum service levels as they would from a traditional solicitors firm.

We concur with the SRA's assessment that the LSBs approach to regulation of ABSs should be:

(a) The application of the same ethical standards, standards of service and consumer financial protections irrespective of business model.
(b) The mitigation of risk through appropriate risk-based entity requirements, the further development of supervisory arrangements for organisations providing legal services, and prompt and effective sanctions for non-compliance.
(c) The avoidance of detailed rules prescribing or proscribing particular business models.

Question 1 – Are there any particular risks to the regulatory objectives that could arise from ABS offering non-reserved legal services?

Traditional law firms are prohibited from setting up separate unregulated firms to carry out un-reserved legal work. If this rule continues to apply to traditional law firms then in order to create a level playing field it should also be applied to ABSs. We are firmly of the opinion that there should be an extension of reserved activities which seems to be permitted under Section 24 of the Legal Services Act. Obvious examples of activities which we believe should be included as reserved activity are as follows:

(a) Will writing
(b) Employment work
(c) Powers of attorney including lasting powers of attorney
(d) Probate work other than preparation and swearing of the grant which is already covered.

We consider that poor service and advice from advisers in these areas may cause distress and loss to consumers and it is essential this is not compounded by an absence of proper and effective regulation - which is likely to lead to a lack of redress. We would therefore like the LSB to give serious consideration to extending the reserved list of legal activities as indicated above.

It is quite clear at present that the public are presently being deceived by unqualified, unregulated and self proclaimed legal advisers offering will writing and employment services which the public perceives as having the same protection in terms of insurance and compensation etc as that offered by solicitors

Question 2 -What should the insurance requirements be for ABSs?

The Law Society's minimum terms provide far more cover than those of any other profession.

If a surveyor lies on his proposal form or if an architect doesn't pay his premium or if an IT consultant works as a structural engineer they are not covered by their insurance but solicitors are in similar situations. Our own minimum terms are the Rolls-Royce terms of any profession where qualifying insurers and not able to cancel the policy for non payment once incepted.

We are therefore of the opinion that either:

(a) All players in an ABS should be subject to the same minimum insurance requirements so as to protect the consumer. (or)
(b) There should be a softening of the minimum terms in line with surveyors and architects etc. Do we for example want to provide run off cover for people who don't pay their premiums and people who deliberately misrepresent their risk, or cover that is not provided to any other profession? The net result of softening the minimum terms will be that possibly premiums will be lower with more insurers entering the market. The downside for the consumer is that we will be diluting their protection. Whatever happens there has to be a level playing field so far as insurance cover is concerned. If the LSB are reluctant to agree to the dilution of solicitors minimum terms then they must ensure that the consumer is similarly protected when dealing with non lawyers.

In the event of the legal services board or the LSB deciding that reserved legal activity shall be subject to the minimum terms and non legal activities shall not, the consumer must be made aware at the outset that it has not been given similar protection.

Question 3 -What are your views on whether the LSBs objective of mid 2011 start date for ABS licensing is both desirable and achievable?

In implementing the Act the LSBs primary aim should be to ensure that robust systems to protect the consumers and the public are put in place by approved regulators licensing ABS. The putting in place of a regulatory framework to ensure the consumer is fully protected will be complex. These issues may take some time to resolve and may cause the implementation process to take longer than originally hoped, as was the case when implementing LDPs as the first stage towards ABSs.

The LSB should work closely with the regulators and have ongoing discussions about the timescales for implementing a regulatory system so that time is allowed for the risks to be properly considered and the regulatory framework put in place to mitigate those risks. Forming a stakeholder group representing all those key interests in the regulation of ABS and regularly consulting within the group will help LSB achieve this.

The Legal Services Act 2007 only allows the LSB to accept licence applications where there is no competent licensing authority or potentially competent licensing authority. There is no legal basis for the LSBs stance that, if there is no competent regulator by the set deadline, they may act as the regulator. It is clear that there are potential regulators e.g. the SRA and therefore the LSB should allow these regulators to put in place robust systems to regulate ABS. The SRA starts from a credible base of relevant experience in regulating legal services, it is well-placed to acquire the necessary expertise to enable it to regulate ABS effectively. Accordingly we do not think the question of whether the LSB should be prepared to licence ABS directly in 2011 will arise.

Question 4 - How do we ensure momentum is maintained across the sector towards opening the market?

There are various external factors that are already driving the move to open up markets. For instance there has been a growth in online and telephone legal advice being provided by regulated and unregulated firms. Big brands such as Which?, Co-op and Halifax already have separate businesses which provide legal advice using a well-known brand name. It is therefore likely that other big brands will start supplying this type of advice and may wish to use the ABS route to do so. A public and consumer benefit would arise from bringing within the scope of regulation, through ABS licensing, as much as possible of the legal advice provided by all such brand owners.

It is difficult to see how the LSB can influence the move to an open market as there are various external factors at play. However limiting uncertainty about the future of ABS and LDPs will encourage more companies to start looking at potential benefits of ABS.

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

Some existing providers will no doubt attract external investment, which accompanied by new management may provide for better services to clients. This is unlikely to increase access to justice to any significant extent, as the consumers who are clients will have enjoyed access to such firms for many years, the firms themselves obviously being successful enough to attract the investment. Such investment may lead either to acquisition of other firms or to existing owners simply enriching themselves. The intent of the introduction of ABS is obviously that of providing competition and innovative services for the many. The financial meltdown may inhibit new entrants to the market setting up new enterprises on any scale. Such new providers of services will have to be as innovative as many existing providers. Access to legal services of some types may be improved but over all access to justice may well suffer unless protective measures are taken.

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?

It is argued that new providers may well be more innovative than current providers although such evidence is very much limited.

It would be a mistake to suppose that existing providers are other than innovative, that will be reinforced as the prospect of new competition becomes real. Those who know and understand the market anticipate greater competition in the areas of property and probate but little else where. There are already over 10,000 entities engaged in often fierce competition which has already produced better service, increased innovation and cost savings. It is doubtful whether ABS will lead to cost savings for small businesses. For large companies it will be a matter for them to determine if they wish to move away from existing suppliers where they should already have the bargaining power to secure economies on cost of services.

The impact of ABS on access to justice and on service users will need to be monitored carefully in case adverse consequences emerge that require regulatory intervention. An example of this will be the potential disappearance of the small law firm from the high street thus restricting the consumers access to justice.

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

Some opportunities will arise for lawyers and firms as a result of ABS including the opportunity to try out new business models and for non lawyers to have a stake in a firm, thus allowing firms to raise capital and gain new expertise. The ability to recruit non lawyers as managers may lead more

lawyers to concentrate on their legal work while non lawyers concentrate on the business aspect of the firm.

Some employed lawyers may be directly exposed to the tension between the profit and compliance with regulatory obligations. It is important that they should retain their sense of individual responsibility for their actions or failure to act. This may be particularly true when non lawyer owners come from an unregulated sector and are unused to compromising profits to meet regulatory objectives. It may also be argued that the tensions between profit and regulatory compliance already occur in traditional law firms, the impact of non lawyer owners is an unknown and the licensing body will need to be aware of this additional issue.

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

The legal profession is already a fairly diverse profession and is becoming more so. We have striven to raise awareness of equality and diversity issues within the profession.

On the limited evidence available, we have no reason to expect any significant overall impact on the diversity of the profession from the introduction of ABS. There is little information regarding how the implementation of ABS may affect areas of diversity such as age and sexuality. However, it has been predicted that ABS will have a negative impact on small high street firms as people move away from using these firms to using large brand names to provide legal services within key areas such as will writing, conveyancing and personal injury work. There are a disproportionately large number of solicitors from BME groups working within these smaller firms and so the loss of a large number of these firms may damage the diversity of the profession.

More positively, the creation of ABS will create new types of firms and new job opportunities. These new job opportunities may encourage those who would not normally consider a career in the legal profession to work within the broader legal profession and thereby increase its diversity.

The creation of ABS may mean that there are more large firms. Larger firms often have greater scope for providing flexible working than small or medium size firms. Increased levels of flexible working may attract a more diverse range of employees.

Equality and diversity requirements required by regulators should apply equally to ABS and traditional law firms.

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

The main educational implications of ABS relate to regulatory concerns. Both lawyers and non-lawyers will need to be clear about the new regulatory framework and their responsibilities within that framework. This will apply to owners as well as managers and should be considered as part of the "fit to own" test. There are special roles for the Head of Legal Practice and Head of Finances and Administration. The people fulfilling these roles will need to be trained on their duties under the Act and how to fulfil them.

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?

Fewer restrictions on financing and ownership may allow law firms to become more flexible and therefore better able to weather changes in the global economy. However the new arrangements will also allow law firms to take greater financial risks e.g. floating on the stock market to gain capital for fast expansion. This will leave some firms vulnerable in a sharp downturn and

arrangements will need to be in place to protect consumers and the public where this does occur. This can, in principle, be secured by requiring ABS to meet the equivalent requirements as other traditional law firms as to indemnity insurance, compensation fund arrangements and handling of client's money. It will be important therefore to consider the compensation fund and indemnity insurance issues in detail prior to the licensing of ABS. It will also be important to consider the new challenges that the scale of such future ABS may pose. The partnership model has a good record in terms of risk which will need to be replicated in ABS notwithstanding a future where equity capital may be raised from non-business owners and where there will be no personal liability on some business owners and managers.

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

We deal elsewhere with the risks to access to justice potentially arising from ABS, and suggest measures to mitigate that.

Leaving that aside, all the risks applicable to traditional law firms will also apply to ABS and therefore regulators should not seek to create a completely different system of regulation for this sector. Regulators should look to minimise any additional regulation and ensure that regulation is targeted at high risk activities in line with the principles of better regulation.

There are some additional risks posed by ABS because they can be owned and financed in different ways from traditional law firms. Key to mitigating risks posed by ABS are strict requirements on fitness applying to all those involved in the ownership and management of law firms, and education of non-lawyer managers and owners so that they understand the rules lawyers must adhere to when practising.

ABS will be able to gain funding from a variety of sources including private equity firms, private investors and stock markets and this may pose a risk to the regulatory objectives. Specific provisions will be needed both to ensure that any investors are fit and proper to own, and to delineate the scope of the influence they are permitted to have on the running of the firm. In some cases ABS will be part of a much larger organisation and its finances will be tied up within this organisation. To understand and mitigate the risks of these new financial arrangements will require training and substantial new expertise for many regulators. More widely education and training may also need to be provided for lawyers so they understand the risks and opportunities.

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

Multi-disciplinary practices providing combinations of service which could give rise to conflicts of duties represent a risk to the regulatory objectives. Sir David Clementi raised concerns in his review about the risks of multi-disciplinary practices (MDPs).

There may be cases where potential conflicts of interest within an ABS are so great that they should not be licensed. Each such possibility will have to be examined by the appropriate licensing authorities on its own merits. One of the aspects which will have to be examined is whether the professional regulatory codes of the proposed participants (if they are subject to such matters) can be harmonised. Each licensing authority will have power to regulate non lawyers within the business, but of course if those persons are also subject to the requirements of their own bodies, there may be conflicts.

If the dispute is between two bodies which are ultimately subject to the LSB e.g. solicitors and barristers, then the LSB will have power to determine the position.

They have no sway, however over bodies such as the Institute of Chartered Accountants in England and Wales. It is hoped that such bodies will enter into agreements with the LSB to grant them such rights voluntarily.

It may be that certain combinations prove to create such conflict that they cannot be adequately licensed. For instance one conflict which has long been recognised is that which might affect a combination of legal and accountancy/auditing provisions. It is feared that the differences between the lawyers code of confidentiality and privilege, and the auditors public duty to disclose discovered wrongdoings, may prove irreconcilable. Only time and a test of applications, will tell.

Wherever firms are owned by businesses with other interests, it will be essential to ensure that the ABS is ring-fenced from other parts of the business and that information about clients is not improperly transferred outside the ABS.

It is possible that new owners may set up complex business structures with multiple companies that may obscure risks – for example, there may be complex referral arrangements and attempts to take non-reserved work out of the scope of regulation. This is a clear regulatory risk and regulators will need to ensure they have the systems and expertise to untangle such structures and consider the risks arising from them as part of a thorough "fitness to own" test. Where prospective owners cannot demonstrate that their business structures are acceptable, their applications should be refused.

There may be instances where the sheer scale of the proposed ABS operation exceeds that of any existing firm, and that scale alone may introduce different regulatory issues. We consider that the development of the different strands of the "fitness to own" test will be crucial in mitigating any risks from non-lawyer owners. We note however that putting in place a robust regulatory system will need to be balanced with ensuring that the system is proportionate and targeted. Licensing authorities will also need to consider the potential impact especially on access to justice, if a large ABS firm were suddenly to leave the market.

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

We agree with the examples provided by the LSB on areas of conflict. The rules regarding conflicts of interests should apply to ABS in the same way they apply to traditional law firms.

One particular area of concern arises over the involvement of institutions that control access to some legal services – for example, insurers – who may well have an interest in the outcome of a case and certainly have an interest in the costs. These interests may conflict with those of the consumer and it will be important to ensure that prospective owners are not permitted to operate ABS in a way which compromises consumer interests or which impedes client access to independent advice.

There are particular challenges arising from conflicting professional duties within MDPs where some of those participating continue to be regulated by non-legal regulators. This will need detailed consideration before MDPs could sensibly be permitted.

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

This question applies to both ABS and traditional law firms as some regulators, such as the SRA, are using entity-based regulation for both types of firm. Regulation focused on individuals tends to focus on individuals' actions and is often reactive. Firm-based regulation allows a more proactive approach and can focus more on the overall systems of a firm. Firm-based regulation allows regulators to focus primarily on the systems in place to reduce the likelihood of, and mitigate, the effects of these mistakes or to stop the mistake occurring again.

This form of regulation, however, will require a change in mind-set by regulators and may mean that regulators will need to employ new expertise. The SRA is already moving to firm-based regulation and its experiences may prove useful for other regulators considering this move.

One of the advantages of firm-based regulation is that it should reduce the risk of individuals being inappropriately blamed for failures of the organisation. There is, however, a danger that heavy-handed regulation will result in sanctions being routinely imposed on both the individual and the firm. We believe that clear guidance should be developed to ensure that this does not occur and indicate when the firm should be primarily responsible and when the individual should be. Without this, it will be difficult for the approved regulator to ensure that a proportionate, transparent and consistent approach to applying the criteria is achieved.

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?

A risk based approach to regulation is desirable both for traditional law firms and for ABS. Regulators will need to consider carefully how they will assess the risk posed by firms given the paucity of data available to them currently. ABS may be complex organisations with multiple sources of funding, which will make assessing the risk posed by each area difficult. Regulators may wish to open up discussions with those regulators who already use a risk-based approach such as the Financial Service Authority (FSA). It is important that, where regulators use a risk based system, this system is transparent and the regulated sector understands how the risk is calculated. Lack of transparency leads to a lack of trust by the regulated sector in the risk-based system.

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

The question of the balance between principle-based regulation and a prescriptive approach is relevant to all law firms, not merely to ABS. The wide variety of business models possible for ABS would make a prescriptive approach difficult to implement and unwieldy. A "one size fits all" approach used in the past has been shown to leave certain sectors feeling that regulators are unable to properly regulate them and leads to a breakdown in trust. Regulators will need to take a more flexible and principle-based approach but good regulators should ensure they make it clear what regulatory risk particular approaches are designed to address and how the future compliance can be secured.

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

An aim of the Legal Services Act was to open up legal services. We agree that having additional regulatory requirements above and beyond those required in the Act may restrict legal services thus requiring there to be a majority of lawyer managers, should be treated with caution. However, Sir David Clementi, in his review of legal services, did conclude that lawyers should be in the majority.

The advantages of having a majority of lawyers are likely to be that, with their knowledge of the law and grasp of ethics, they are less likely to take risks which compromise their professional

integrity or their duties to clients. On the other hand, it could be argued that not all lawyers have the entrepreneurial or managerial skills to bring reform to the market and requiring a majority could delay innovation.

Regulators will need to consider what is the minimum number (or proportion) of lawyers needed in ABS or in their management teams and it maybe that different approaches would be needed for different ABS. This is an issue which we would expect individual regulators to consider in detail in their own consultations about proposed licensing rules.

We believe for small and very large ABS a requirement to have a majority of lawyer managers may pose difficulties. In small firms where there are only three managers – the requirement to have two lawyer managers may be unduly restrictive. In very large firms the requirement to have a majority of lawyer managers may distort the corporate structure.

However we believe that there will need to be enough lawyer managers to oversee that legal services are provided competently and there is a full grasp of ethical requirements within the firm. For this reason a regulator may wish to consider requiring a percentage (whether or not a majority, either by number of individuals or by percentage ownership) of managers who are lawyers in specific cases.

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?

Part of the fitness test for those taking on the roles of HoLPs and HoFAs should be their knowledge about the role and competence to perform it. For example, the HoFA may need a financial qualification or experience in handling financial matters.

HoLPs and HoFAs should in addition be subject to the same fitness tests as any non-lawyer manager within a firm. Their seniority within the organisation, their experience and ability to affect change should also be considered.

Any criteria for selecting HoLPs and HoFAs set down by regulators will need to be flexible. The requirement for a large firm dealing with a substantial case-load may well be very different from that for a small, local ABS. For this reason the main responsibility for choosing appropriate people for these roles should rest with the ABS in question, possibly with guidance from the regulator.

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 might first be beneficial to consider defining what "higher risk" is and how the risk would be assessed. It is in general difficult to see why authorities would wish to grant licences to bodies which can at the outset be recognised as high risk. The principle should be that the onus is on applicants to demonstrate that they – and their business model – are suitable for the grant of a licence.

Where firms are viewed as "high risk" then regulators should consider what factors lead to that assessment of risk and whether the firm could do more to mitigate them. If there are actions that a firm can take to minimise risks it should do so before it is reconsidered for licensing. If the risks are inherent in the business then regulators will need to consider the risks to the consumer and profession of granting a licence to such an organisation weighed against the potential benefits. It is conceivable that some ABS may, by the nature of the work they undertake, be high risk in the sense of there being a significant risk of business failure but they may also fulfil a consumer need that may not otherwise be met.

If an entity is "higher risk" because their internal governance is poor or because of doubts about the integrity and fitness of their owners then they are not a suitable entity for licensing and should not be licensed by any regulator.

This is a new area for regulators and a high profile failure early on would damage the reputation of both ABS and their regulators, both nationally and internationally. For this reason careful consideration should be given to licensing ABSs that carry a high risk. Regulators should be mindful of financial risks posed by ABS as well as regulatory risks.

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

To ensure a level playing field, the same requirements must apply to ABS as to other comparable regulated practices. Many of the risks associated with ABS exist for other regulated legal practices and there will be no need for a different approach. Only where there are demonstrable additional risks, e.g. outside financial investment, should the regulator treat ABS differently to other regulated legal practices. In such cases the approach should be proportionate to addressing those individual risks.

Careful consideration should be given to monitoring markets to ensure that availability of services is not distorted by bulk supply of a particular type of service.

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 condition?

The issue of access to justice was discussed extensively during the parliamentary debate on what is now the Legal Services Act. The importance of access to justice was highlighted by its inclusion as a regulatory objective in Part 1 of the Act. Parliament highlighted specific concerns regarding the effects of ABS on access to justice and the Bill was amended to ensure that licensing authorities had rules in place that made sure access to justice was considered when assessing applications for potential ABS. Parliament's intent was clear and regulators will need to ensure they are mindful of access to justice when licensing ABS.

The regulator will need to consider what it means by access to justice and the Law Society would be anxious to help in defining the concept. In our view, it should involve access to a choice of appropriate legal advice in the main areas of law likely to affect those wanting or needing to use a service. ABS may assist this in some areas. In others, however, it is possible to envisage that a single supplier or couple of suppliers may take such a proportion of the business that there is no meaningful choice for the consumer.

It is difficult to predict the outcome of opening up the market to allow ABS. The market has changed significantly since the creation of ABS was first suggested. In some areas, ABS may increase access to justice, particularly if they stimulate innovative ways of providing legal services. However, we have concerns that ABS may restrict access to justice in certain areas if the risk is not adequately measured and managed, especially if ABS focus on only the most lucrative areas of the legal services market. There is a risk that loss leading or major penetration in these areas could eliminate smaller firms that provide a broad range of services and supplement less profitable lines of complex or public interest work. These less profitable areas of work include legal aid work but also work paid for privately in areas such as family law. This could potentially result in fewer sources of these types of advice, particularly in rural communities but also in many suburban areas too. This applies particularly to cases involving vulnerable consumers. A power must be reserved

to enable the regulator to act if the market is distorted and there must be monitoring to ensure any such distortion is identified early enough for the regulator to intervene.

Parliament intended to ensure that the introduction of ABS did not inadvertently undermine access to justice, and that ABSs were not able to cherry-pick or loss lead services to the detriment of the overall position of the consumer. This issue of protection is crucial in the current financial climate, which has made smaller firms vulnerable to the loss of profitable areas of work which currently cross subsidises less profitable work. Regulators should be mindful of this when considering access to justice.

It is possible that deregulation of the market may stifle rather than stimulate competition and consumer choice with a few big players coming to dominate the market. This has occurred in some areas of the country when other markets have been deregulated, for instance public transport, and regulators should be mindful of this.

One approach regulators may wish to take to ensure access to justice is to regulate market share to ensure there is appropriate provision of legal service within a given geographical area. For instance there may be a need to ensure that there are more than two suppliers of legal advice in one area to ensure two parties can get independent advice over a contentious issue and have a choice of adviser.

One issue which will need to be determined is whether there should be publicity given to ABS applications, at least of a certain size, in order to allow potential objections to be made on access to justice issues, amongst other things.

It is impossible to predict at present how many licences will or should be rejected, or granted subject to conditions because we cannot know now how many applications will raise access to justice concerns. It will be important for regulators to carry out an adequate impact assessment – considering access to justice, as well as the impact on small and medium enterprises (SMEs) and on equality and diversity – before finalising their proposed licensing rules. It will also be essential to carry out an impact assessment before deciding whether to grant an application, and if so on what conditions, wherever it appears that an individual application may have an adverse impact on access to justice. The cost of these assessments should fall on the applicants.

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

As with traditional law firms, ABS should be required to comply with appropriate arrangements for indemnity insurance and compensation. The level of consumer protection should be the same for ABS as for other comparable law firms.

We are concerned at the suggestion that regulators should not seek to attain a "zero casualty" outcome. Concern has already been raised as to the potential scale of ABSs. We would thus suggest that the concept of establishing capital adequacy rules is investigated further, and that regulators will also need to consider the level of debt and gearing being used by the new owner to acquire a stake in the ABS.

There is a risk that the failure of a fast growing firm through dishonesty may exhaust whatever compensation fund arrangements are in place and thus leave consumers unprotected. While the risk of this occurring is low because all those involved in running the firm would have to be involved in the dishonesty, the consequences would be severe. Currently the liability of the Law Society's compensation fund is up to £2m per client. A collapse, through dishonesty, of a large firm with numerous clients may well leave a compensation scheme struggling to cope. Therefore careful consideration will need to be given to how the financial viability of ABS and their associated

compensation fund will be assessed. This risk will be particularly high where an ABS has high levels of debt. Regulators will need systems in place to identify this and to assess the risks associated with a firm carrying a high level of debt either directly or through an owner.

The principle is thus that consumers should enjoy the same protection against dishonesty in an ABS – both in terms of scope of cover and certainty of pay-out – as they currently enjoy in respect of other ordinary law firms. It cannot be assumed that all ABS will be large, or immune from risks of this sort. The precise method of providing that consumer protection needs further consideration. It would not be acceptable for the burden on existing firms to be increased as a result of any failure to ensure probity amongst ABS, if that should happen. One possibility would be to examine whether a bonding scheme could operate for ABS, or indeed more widely within the legal sector.

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

To ensure a level playing field and clarity for consumers, complaints against ABS should be treated in the same way as complaints arising from other regulated firms. Consideration will need to be given to how complaints regarding non-legal work provided by an ABS are handled by the OLC and regulators. If ABS are – as they should be – distinct from the rest of their owner's activities, the regulatory and complaints handling structure should cover the non-reserved legal services that they provide as well as reserved services.

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?

We agree that the "fit to own test" will be crucial in mitigating the risks to the regulatory objectives. We also agree that it is important that a licensing authority should avoid disproportionate requirements when setting the "fit to own test" as this may discourage non-lawyers wishing to invest in ABS. Those who would pass the "fit to manage" test should normally also be regarded as "fit to own".

When considering the elements of the test, the LSB may wish to consider the approval requirements used by the FSA to assess whether someone is fit and proper to be an approved person and the tests used by the SRA in assessing new managers in LDPs. The onus should be placed on prospective owners to show they are "fit to own" rather than on regulators to show the opposite.

Regulatory intervention should be based on risk. If there is a higher risk posed by a higher percentage ownership then the fitness to own test would need to be more stringent to mitigate that risk. Our current view is that the higher the percentage owned by one individual, the more stringent the test should be. For instance it could be decided that not only would there be a 10% level but also thresholds of 20% and 30% where ever higher levels of investigation and approval would be applied.

Interestingly and, surprisingly, much ignored - is the ability for a licensing authority to impose upper limits for non lawyer involvement. They can decide that either or both of the two limits might apply, namely a cap on the amount which any individual may hold and or a limit on the aggregate permissible non lawyer involvement. Therefore, the idea of "Tesco law" i.e. the entire ownership of a legal services business by non lawyers, is not a done deal, despite the public perception to the contrary.

In the future, regulators will need to consider how they can assure themselves that an owner continues to be fit and proper to own an ABS.

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?

During the initial phase of licensing regulators will need to consider applications from special bodies on a case by case basis considering the individual circumstances. The risk will vary from one type of body to another and therefore the decision on licensing these bodies will vary depending on the type of organisation. Regulators will need to be transparent about how they have reached a decision in each case to ensure the process is not perceived to be arbitrary or unfair.

The special provisions applied by the Act to special bodies are in place because there is lower perceived risk as there is no commercial motivation. However it should be noted that some not-for-profit organisations do have trading arms and therefore may be commercially motivated. Regulators will need to consider whether a not-for-profit organisation has commercial motive when assessing the risk it poses.

While not-for-profit organisations may not always have a profit motive they are still motivated to raise money, grow as organisations and succeed and this should be considered when assessing the risk posed by these organisations.

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?

Special bodies will be providing legal services to vulnerable consumers. These consumers should be protected in the same manner as consumers of legal service from other regulated providers. Licensing special bodies will enable regulators to ensure that these special bodies provide a competent and ethical service.

These special bodies are unlikely to hold client money and this coupled with the lack of commercial motives may make them lower risk for licensing purposes. Any proposed licensing system and fee structure should take account of this lower risk.

Question 28 - Are there any other issues that you would like to raise in respect of ABSs that are not covered by previous questions?

As we have highlighted previously we consider that the major potential risk to the regulatory objectives comes from external ownership and will need to be mitigated by the "fitness to own" test. Regulators will need to put in place a robust test and may need to obtain additional expertise to unravel complex models of ownership.

As noted above MDPs providing combinations of service which could give rise to conflicts of duties which also represent a risk to the regulatory objectives. For this reason we consider that wherever firms are owned by businesses with other interests, it will be essential to ensure that the ABS is ring-fenced from other parts of the business and that information about clients is not improperly transferred outside the ABS. New investment will open up the possibility of firms becoming highly leveraged. Regulators will need systems to be in place to identify this and to assess the risks associated with a firm carrying a high level of debt either directly or through an owner.

One practical issue which will arise is how the cost of ABS regulation should be met. The ongoing costs will obviously be met by the ABS themselves. But there is a strong case for saying that ABS should also, over time, meet the costs to licensing authorities of drawing up and developing their licensing rules, and establishing the necessary infrastructure for regulating them. Such recovery

should commence with the ABS licence application fee, which should be set to include an element of such cost recovery. This approach would of course be consistent with the approach the Government itself has taken to recovering the implementation costs of the Legal Services Board and the Office for Legal Complaints.

The LSB must avoid conflict between different regulators. The licensing rules must contain provisions as to how regulatory conflicts between regulators will be avoided. Our regulatory framework for LDPs avoids conflict by applying rules to both the entity itself and to all managers and employees. Essentially, entity regulation which is the underlying premise of the LSA, avoids conflict by making the entity regulators rules "trump" the rules of a different regulator of any individual in the firm in the event of a conflict. This is confirmed by Sections 52, 54 and 103 of the Legal Services Act. In any ABS model where legal services are ring-fenced from the delivery of non legal services, we believe this form of entity regulation deals with the potential for conflict.

It is important that we clarify for the benefit of the consumer the difference between regulated and un-regulated providers of legal services. Members of the public are entitled to be able to make such distinguish at the outset.