Response to LSB's paper on Alternative Business Structures

"Alternative business structures: approaches to licensing"

SRA Response

Executive summary

1. The Solicitors Regulation Authority (SRA) welcomes the outcomes-focused approach to regulation set out in the LSB's paper. The SRA has recently published its strategy paper on outcomes-focused regulation - "Achieving the right outcomes" – which demonstrates the synergy that is now developing between the LSB's vision of an "outcomes-focused approach" to regulating ABS and the SRA's commitment to both realising the potential of the Legal Services Act 2007 and making a step change in the way it regulates solicitors, traditional law firms and Legal Disciplinary Practices (LDPs), and, in future, ABS.

2. The SRA's primary objectives in moving to outcomes-focused regulation and implementing ABS are to:

    a. transform regulation for the benefit of consumers, by focusing our regulatory regime, and our supervisory and enforcement activity, on the outcomes to be achieved by firms for consumers;

    b. achieve similar levels of consumer protection for clients of both firms of solicitors and ABS and a harmonised regulatory regime; by and large, we do not believe ABS presents risks that are substantially different in nature from those presented by traditional law firms;

    c. establish a regulatory regime for all types of firm that it regulates that is proportionate to the risks posed to the regulatory objectives, based on our assessment of available evidence;

    d. establish a regime which is sufficiently flexible to enable firms to be innovative in the provision of legal services and to develop controls suitable to their risk profile and business model.

3. The SRA's responses to the LSB's paper are based on these objectives.

4. The SRA also believes that similar outcomes and standards should apply to all ABS, where such an approach can be justified on the basis of the risks to the regulatory objectives. However, our primary concern must be for parity amongst the firms that the SRA regulates.

5. We agree with the LSB on the high-level outcomes that it has identified for Licensing Authorities (LAs) and consumers. We believe that it is appropriate that these outcomes are high-level, and that it should be for each LA to define outcomes for the firms and the sector of the legal market-place that it regulates.

6. Of the outcomes identified by the LSB, we are concerned that those relating to indemnity and compensation should not result in the lowering of consumer protection, or in any transfer of risk from the firm to the consumer.

7. We support the objective of the LSB for LAs to be risk-based regulators. Risk-based regulation of necessity means that information will be required from firms throughout their lifecycle in order for the LA to determine where risks exist, the degree of risk to the regulatory objectives, and a proportionate response both in terms of its regulatory regime and its approach to supervision and enforcement. Risk-based regulation also enables the SRA to be proactive in protecting clients and the general public, rather than reactive.

8. Determining the right approach will often require finding the right balance between:

   a. Consumer protection and competition. Where barriers to entry are removed – and we support such removal – this must not be at the risk of consumer protection;

   b. Prescription and flexibility. Our outcomes-focused approach is very much about stripping out unnecessary detail. Prescription does, however, have a role to play in providing clarity, for example in relation to the treatment of client money or on licensing criteria. Where prescription is needed, we believe that this should be provided by the LA, rather than the LSB;

   c. Discretion and transparency. We agree with the view expressed by the LSB that some situations cannot be dealt with in advance by regulation, but rather require the exercise of discretion on a case by case basis. Having said that, regulated firms quite rightly demand transparency and consistency from their regulator so an appropriate balance has to be achieved.

9. The new thinking and challenges presented in the LSB paper are welcome. This is the right time for the challenges to be made. Whether it will be possible to resolve all the issues in the timescale set for the issuing of the first ABS licence is not a reason to ignore the challenge. However, in some cases, it may be more important to deliver the new regime, with the significant reductions in restrictions on ownership that it brings, within the agreed timescale rather than seeking to resolve all the issues in advance and potentially jeopardising the timescale, provided that this can be justified from a risk perspective.

10. The LSB's paper highlights the need for further analysis. We believe that this is particularly the case for:

    a. Indemnity and compensation requirements;

    b. Reserved/non-reserved legal activities;

    c. Multi-disciplinary practices;

    d. Fitness to own;

    e. Head of Legal Practice (HoLP) and Head of Finance and Administration (HoFA);

    f. Special bodies.

We strongly support the LSB's direction of travel in most such areas and welcome the initiatives of the LSB to address these issues. We need to work hard on achieving practical solutions, learning from other regulatory arrangements. In most of these areas we see little difference in principle between the views of the SRA and the LSB, although we may have different views on the detail.

Introduction

11. The views of the SRA set out in this response have been developed as a result of considering responses to our own and the LSB's earlier consultations, and on continuous engagement with both the LSB and other stakeholders.

12. We have set out our detailed responses to the questions raised in the LSB's paper below.

Detailed responses

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

13. As can be seen from our comments in the Executive summary, we strongly support this, although our consultation paper "Achieving the right outcomes" recognises that there are some risks, but we consider these can be managed. The outcomes set out in the LSB paper are intended to guide prospective LAs and some, we imagine, will form part of the outcomes set by LAs for firms.

a. Should all LAs have the same core outcomes?

14. We agree that one set of core outcomes should apply to all LAs, but set at a sufficiently high level to allow LAs to develop regulation in the way that suits their section of market. The LSB should provide the flexibility to allow LAs to set their own outcomes by reference to their particular sector of the legal services market and the business models that operate within it. For example, we expect that the SRA's new Code of Conduct will be based on compliance with principles and achievement of defined outcomes.

b. Are the proposed outcomes appropriate?

15. We agree with the overall approach to outcomes, and with all but a small minority of the core outcomes. Most are set at a sufficiently high level to allow some flexibility of approach. The only outcomes we have any significant concern about relate to indemnity and compensation and our views are set out later in this response. We do also have some concerns as to how some outcomes, particularly those that apply to all LAs, can or should be measured, such as the outcomes relating to access to justice. This will require further work. Certain other outcomes we consider need some further clarification, such as the outcome relating to reserved/non-reserved legal services as explained later in this response.

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

16. The SRA took a significant step towards more entity-based regulation with the benefit of changes to our statutory powers made by the Legal Services Act, and the introduction of legal disciplinary practices. However, we strongly believe that our regulatory regime should be applicable to both firms and individuals. For this reason, we do not propose to set separate requirements for firms and individuals, which could, we believe, create an expectation gap, in which individuals within a firm do not consider themselves responsible for compliance with requirements, with the result that the firm as a whole is not achieving the desired outcomes.

17. The important distinction between the responsibility of firms and individuals comes at the point where problems are identified. Should we decide to take regulatory action in relation to a situation, we would form a view on whether it was appropriate to discipline the firm as a whole and/or individuals. This will be discussed in greater detail when the SRA publishes its OFR Roadmap in May 2010, which will include our approach to enforcement.

18. The more difficult issue is how to provide for comprehensive and consistent customer protection in circumstances where there are overlapping entity regulators and further work and discussions are required on this.

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

19. We agree with the thrust of this chapter. What is critical is that consumers and public confidence in of the profession are safeguarded by a robust authorisation process, but one that does not seek to prevent firms from exploring innovative funding structures and business models. The statutory framework provides some difficulties and a common sense and proportionate approach, favoured by the LSB, must be right.

20. Given that we see no significant issues of principle in this area beyond those matters dealt with in this response, we consider the next step should be for the LSB and potential LAs to work on the actual processes**.** In considering these processes, we believe that it is important for LAs to have sufficient flexibility, to allow them to react to emerging risks, whilst at the same time providing transparency of process for new market entrants. In other words, we believe that it is important that the LSB is not over-prescriptive of the approach to be adopted by LAs.

a. Should the tests be consistent across all LAs?

21. See above.

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

22. We broadly agree with the "Key proposals" as summarised in paragraphs 69 – 73, subject to the comments below and to those set out in answer to questions 2.c – j.

- Paragraph 69: This states that the test for owners of ABS will include a declaration of criminal convictions. It is not clear from this if checks can or must include CRB checks as well as self-declaration. Our current view is that we would want to continue CRB checks for all new managers, and for owners with a material interest and similar tests for those from other jurisdictions. All solicitors have to complete a CRB standard disclosure prior to admission, and prospective non-lawyer managers are now required to do so as part of the approval process for LDPs. (We would not normally expect to re-check solicitor-managers or approved non-lawyer managers in an existing LDP which becomes an ABS although notification requests apply to any change in their circumstances which would influence our assessment.)

- In our experience sole reliance on self-declaration will not provide the appropriate level of public protection or confidence in the regulatory

system. The FSA uncovered similar problems with self-declaration a number of years ago through random testing.

- Paragraph 70: Whilst we agree that the external ownership tests required by the Act must be implemented in a proportionate and – we would argue – transparent way, we disagree with the assumption that, "….in most cases, people with significant influence are unlikely to have a negative influence on an ABS". Experience in other markets would suggest that people with significant influence can have a negative impact on an organisation, hence the need for a robust assessment.

- Paragraph 71: We agree that there should not be a need to reapply the fitness tests regularly, and that there should be a notification requirement. A regulator's on-going assessment of risk is dependent on proper flows of information between firms and the regulator and it is therefore important that a LA can require an annual return which would include confirmation that all necessary notifications (e.g. information about criminal convictions since the original application was made) have been made.

- Paragraph 73: We broadly agree that this requirement is sensible for the avoidance of doubt, and would be interested in the views of others as to whether this should be required of unlisted corporate ABS, with shareholders or other forms of ABS.

- Paragraphs 81-87: The guidance suggested in these paragraphs is sensible. The suggestion that the New South Wales model for divesting unfit owners of their shares and requiring them to be bought back by other shareholders of the firm could be followed. We would have no objection to this in principle. However, to the extent that there are already divestiture provisions in Schedule 13 LSA (which are consistent with the FSA model for unfit owners of FSA-authorised firms), the LSB would have to ensure there were no conflicting provisions or arrangements.

- Paragraph 88: We can see advantages in there being "a uniform test based directly on the requirements of Schedule 13 to the Act, for all owners of an ABS", including the lawyers. This could be combined with some flexibility so that if we have previously carried out a fit and proper test to that standard when the person was authorised as an individual, we do not repeat the test.

- Paragraph 89: We broadly agree with the list of factors which all ABS licence applicants must be required to declare in respect of their owners, provided this is intended as being generic or indicative, rather than exhaustive. LAs will need considerable flexibility within each of these headings to require detailed information about owners' probity and financial soundness. For example, the FSA's regime for corporate controllers includes questions concerning administrative as well as criminal cases. We may want to require similar information.

- Paragraph 90: We agree there are both legal and practical issues that need resolution but the principle of being able to check with other bodies must be right.

- Paragraph 93: We agree broadly with this, and this is the basis of our current arrangements. However, if an ABS application were received

from an applicant with a known track record of poor management in legal businesses we would want to take that into account when initially considering whether or not the imposition of a licence condition would assist or potentially the information may lead to refusal.

- Paragraph 110: We disagree with the suggestion that all individual partners in a large partnership need not be subject to the test if they do not hold a material interest. The power at paragraph 3(2)(b) of Schedule 13 for a LA to provide through its rules that all partners have a material interest was included by Parliament in the public interest. Partners are managers for the purpose of the LSA, and each can legally bind a firm to a particular course of action and so, by default, are persons of influence. It is central to firm based regulation that the primary focus of regulatory activity should be on those at Board (or equivalent) level who are responsible for the activities of the organisation, and that they should not be able to delegate that responsibility. With that in mind, we believe our arrangements should provide that all "managers" (as defined by the LSA) should be subject to the "fit to own" test, as between them they hold that responsibility (see also our comments below on non-lawyer managers who are not owners).

  In addition, legal and factual disputes can arise between partners about the extent of their influence over the partnership. It would be much clearer for everyone for a LA to apply the fit and proper test to all in the role of partner, even if they do not own a "material interest".

- We think it is important to say more on the role of managers in a firm. Managers are able to exercise significant control over the day-to-day operations of a firm. For this reason, the effects of serious misconduct on the part of a manager are likely to be felt more directly and immediately by the firm and its clients than similar behaviour on the part of a purely "external" owner. It would be a source of concern, therefore, if non-lawyer managers (e.g. directors) with no ownership interest in an ABS do not have to be approved under the Act. If, as we argue above, all partners should be subject to a fit and proper test, it would be anomalous for us not also to be able to approve managers with no ownership interest who were directors or members.

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

23. Solicitors, registered foreign and registered European lawyers are exempted by secondary legislation from the Rehabilitation of Offenders Act 1974, thus enabling the SRA to enquire about spent convictions. The Rehabilitation of Offenders Act 1974 (Exceptions)(Amendment)(England and Wales) Order 2008 applies to a non-lawyer manager of an LDP, thus enabling the SRA to take spent convictions into account in the approval process. Information received on convictions, either through self-declaration or CRB checks, is assessed against published guidelines to ensure reasonableness and proportionality, and there are proper procedures for appeals.

24. We believe it would be entirely consistent with the current statutory framework, and essential in the public interest, for the SRA to be able to enquire about any spent convictions and conduct CRB checks in relation to managers of an ABS. This may require a new amending Order.

d. What is your view of our suggested approach for considering associates? Is there an alternative approach that would work better in practice?

25. In our view the correct interpretation of the legislation is more likely to be that stated in paragraph 99, rather than paragraph 98. With regard to the three approaches suggested by the LSB at paragraphs 102-104:

    a. a de minimis test could prove useful but requires further investigation. In our opinion a de minimis test could be abused by individuals seeking to avoid the scrutiny of a fit to own test;

    b. we do not believe that certain categories of associate should be presumed to be fit to own, particularly given recent events in the financial services market. However, we do agree that the nature of the entity (e.g., an institutional investor) should influence our assessment;

    c. we agree with the proposal for the appropriate imposition of licence requirements.

We would welcome further detail and discussion on these proposals.

26. The paper talks about an ABS obtaining enforceable covenants with persons of influence. We are not convinced that this would be effective. We foresee a number of legal and practical challenges that would be very difficult to overcome. For example, we would have to be confident that the ABS could (and would) legally enforce the covenant, and might have to see (if not approve) the covenant in order to ensure that it contained the necessary protection. Also, for the covenant to work, its terms might have to spell out in sufficient detail the type of behaviour it was trying to prohibit and when it might be invoked, while at the same time not unlawfully restricting the contractual rights of the ABS and the "person of influence". Overall, we do not consider this an option worth pursuing.

27. We do, however, agree that in practice it will often be the supervision regime that identifies persons of influence, and in those circumstances a LA would want to have a range of tools to manage any risk.

28. We note the proposal in paragraph 107 that a LA would be expected to take into account the reporting requirements on listed companies to identify owners of 3% or more of shares. We agree in principle that this might assist in devising a proportionate approach to the question of "associates".

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

29. Paragraph 88 proposes that the "ultimate beneficial owner of an ABS should always be declared and that this information should be made public". Whilst we agree that this information should be disclosable to the LA, we are not sure of the benefit of making such information publicly available, weighed against the likely cost. There are practical challenges too: in some cases "ultimate" beneficial ownership is likely to be so diffused through multiple layers of ownership that the practicalities of determining where to draw the line for regulatory purposes would be considerable. A de minimis level might need to be adopted. We note in this regard that the Gambling Commission investigates ownership "up the chain" until one of a number of interests is

identified – most notably , the point at which no entity owns 3% or more because the interest in the applicant has been diluted through corporate layers to below 3%. Such owners do not have to be named in the application for an operating licence.

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

30. We support the suggestion that flotation of licensed bodies should be permitted (paragraph 72). The task for LAs will be to adapt their rules in a proportionate and risk based way to deal with any special considerations applying to listed companies.

31. The paper places considerable weight on the proposal – adapted from the approach developed in New South Wales – that a listed company be required to make a statement in its constitutional documents that duties to shareholders "do not compromise" the duties owed by the ABS to the court and to the client. While we see educational (and possibly deterrent) benefit in this, we are less convinced that a constitutional device could enable lawyers' duties to take legal precedence over those owed under, e.g., company or financial services legislation – if this is the desired outcome. Section 176 of the LSA already gives lawyers' professional duties statutory status, and presumably Parliament did not intend to go further.

32. In New South Wales, the legal status of the "hierarchy of duties" appears to be untested, and in 2009 the Office of the Legal Services Commissioner was reported to be in discussion with the state government with a view to obtaining clearer legislative backing to the priority of lawyers' duties.

33. There are wider issues to address with floatation. For example, there may be conflicts between any duty of disclosure under the rules of the relevant stock exchange and the firm's duty of confidentiality to the client. We think that such situations can be managed through appropriate requirements, but we need to work out the detail.

g. Overall, are any modifications needed to ensure that our approach works in very small companies?

34. The approach looks broadly satisfactory.

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

35. The paper does not appear to propose a "change", as such, to the definition of a restricted interest. We would be reluctant for the definition to change if this meant removing altogether the power of a LA to define a controlled interest, however, at this stage we do not anticipate imposing an additional controlled interest test.

36. Our initial view is that there is no prima facie reason for regarding a person assessed as fit and proper at the 10% threshold as being unfit simply by virtue of owning a higher interest; or - to look at the issue from the other direction - an unfit person is always unfit, regardless of the extent of their ownership, above the minimum set in the Act.

37. Other considerations might support this approach. For example, an undertaking with a long term strategy gradually to increase its stake in an ABS might be deterred from becoming involved at all if it considered the controlled interest threshold(s) set by an LA to be unduly burdensome or disproportionate. In that case controlled interest tests might be regarded as inhibiting the development of ABS, and as not operating in the public interest to that extent.

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

38. See our comments in answer to question 2.d.

j. How should the LSB respond to the information it receives about information on action taken against people that falls short of disqualification?

39. We find it difficult to respond to this without further clarification of the issue. The answer may depend on the publication policies of LAs in promoting regulatory decisions which fall short of disqualification and on information sharing arrangements between regulators.

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

40. Our primary concern in relation to both indemnity and compensation is that consumers receive the same level of protection whatever the type of firm with which they are dealing. That level of protection should be proportionate to the risks.

41. We believe it would be appropriate for the LSB to take an outcomes-focused approach to compensation and indemnity arrangements that focuses on identifying the minimum level of customer protections required, but leaving it to LAs to deliver those outcomes in different ways, giving necessary flexibility for the different markets. Currently there is no "one size" to fit all because the different sectors of the legal marketplace give rise to different levels of consumer risk. Some of those require, for example, a significant compensation fund, but that is not necessary in other areas. We do not believe that the LSB should specify in detail how the arrangements should be provided. We would also urge the LSB to take the current outcomes provided by most existing LAs as the starting point, as we do believe there is some danger in disturbing the current protections in advance of ABS.

42. Our preference would be to adapt our current scheme, requiring insurance on Minimum Terms to be provided to all traditional law firms and ABS, regardless of the activities undertaken. This would minimise barriers to firms investing in new areas of work and ensure that clients remain protected even if a firm strays across a boundary that it is not licensed to carry out.

43. We do not assert that current SRA arrangements are perfect and we are currently considering a number of adjustments and would welcome further discussion by the Task Force of this issue. However, we do not believe that there is clear evidence that the current arrangements will operate as a barrier to new entrants to the legal services market. We think that if some of the suggestions made in the paper were implemented then there could be a considerable reduction in consumer protection.

44. The SRA's current arrangements are intended to ensure that consumers who are significantly adversely impacted by negligence or dishonesty receive some compensation. The limit is set at a level that will provide compensation if a not uncommon mistake (e.g. negligent failure to issue a claim within the limitation period) is combined with a catastrophic personal injury. The level is not chosen because claims up to that level are common, and so the fact that claims between £1m and £2m are rare is not the relevant factor. We all buy travel insurance which would cover us for a serious injury taking place in a country where medical treatment is expensive. We know that the likelihood of that happening is rare, which is reflected in the premium, but are aware that the impact would have serious financial consequences for most of us. The current scheme also ensures that consumers are paid (to the minimum level) in almost all circumstances when a firm itself is unable to pay.

45. We, therefore, do have concerns with some of the outcomes in this chapter. The first, "ABS provide appropriate levels of redress and protection against negligence and fraud" is acceptable, as is the second, although we would delete the word "likely" for the reasons explained above. We do not consider that the third can be properly described as an outcome. It is difficult to see how a regulator could or would want to prevent an ABS carrying cover higher than the minimum required by legislation.

46. We also have real concerns with the fourth outcome, as we cannot see how consumers can be expected to make choices without transferring some of the burden of the risk to them.

47. In principle, the fifth outcome is appropriate but the word, "unduly" must be read to allow schemes to operate that do deliver the appropriate protection levels to consumers with the knock-on effect that there may be some impact in these areas. However, the balance has to be right. The Task Force arranged by the LSB has begun with a useful discussion of these issues and we would urge that the work of that Task Force continue. We believe that responses to the LSB may confirm that many potential external investors favour investing in a regulated market, in particular, where that regulation includes minimum levels of insurance and compensation. We have not been contacted by any prospective ABS arguing that they would not wish to carry similar levels of cover.

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?

48. This to us is one of the most important and difficult issues which requires a considerable amount of further work by the Task Force. In some cases it may be so easy to distinguish legal services from other non-legal activity that an insurance policy would be able to provide an appropriate and different level of cover for each activity. In other cases there may need to be a requirement for one policy to cover all activities at the same level because of the difficulty in distinguishing between those activities. We do not believe that this is an entirely new issue for insurers and believe a common sense system can be found. We would not want the apparent difficulty in deciding this issue to be a barrier to MDP models and it may be that this is an area where a starting position with one or two options may be desirable and for adjustments to be made in the light of experience.

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

49. We do believe that there should be minimum PII levels which are broadly the same for all LAs unless there is a good reason for distinction because of the different type of activity. We do not support any proposals that there should be different levels for different types of legal activity e.g. one minimum level for probate and another for conveyancing. That will simply add to complication, confusion and increased cost, not least because current activities of an ABS are not necessarily the same as past activities and claims are more likely to be made in any year on the basis of activities conducted some years previously.

c. Are Master policy arrangements appropriate for ABS?

50. If a Master policy can deliver appropriate consumer protections at appropriate cost then they should not be prohibited. It would be for the LA initially, and ultimately the LSB, to assess whether the arrangements for particular LAs that included the Master policy delivered the necessary consumer protection outcomes.

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?

51. This subject is difficult. The current SRA arrangement provides that consumers are protected to the minimum level in relation to a claim arising for up to six years after the closure, for whatever reason, of a practice. The SRA scheme also provides some cover for claims arising after six years. With legal claims it can take some time for negligence to become apparent. We are considering how we can improve the current arrangements to give sufficient commercial freedom, but if consumers are to be protected in these circumstances then there has to be some method of payment. We would prefer to be in a position to make sensible adjustments over time and do not believe, by and large, that the current arrangements are likely to prove a disincentive for many forms of corporate new entrants to the market, who are likely to deliver significant benefits to consumers.

e. What should the requirements be for compensation funds in ABS?

52. Each LA should be able to provide for compensation outcomes in different ways. An outcome-focused approach would allow for distinctions to be made between those parts of the legal profession who do not currently hold client money and arguably do not require a compensation fund and those who do. The requirements for compensation funds very much reflect the requirements for insurance as currently different regulators provide for the consumer outcomes in different ways, using a mixture of insurance and compensation funds, and we believe that that ability should remain.

f. How could a compensation fund work in an ABS environment, in particular when the services offered by the ABS may be much wider than legal advice and where an AR may not currently have a compensation fund?

53. This is part of the wider debate on MDPs and further work which we are undertaking at the present time with other regulators. We would be

interested in any views. However, this is not a new problem as the Financial Services Compensation Scheme currently provides compensation in relation to some, but not necessarily all activities undertaken by an FSA authorised firm. We are currently assessing the reach of an LA from a legal perspective.

4. Do you agree with our position on reserved and non-reserved legal activities?

a. Do you agree that ABS should be treated in a consistent way to non-ABS?

54. We agree that this important issue needs to be addressed and support the basic principle of the statement. There is a clear benefit in LAs being able to set the regulatory position in good time for the introduction of ABS but at present the matters requires further investigation. In addition the position may alter following the LSB's planned review looking at whether unreserved activities should be regulated.

55. The SRA currently prohibits firms of solicitors from conducting non-reserved legal services using a separate business. One option for ABS would be to apply a similar regime to our current separate business rule to ABS preventing their providing core legal, but unreserved, activities through an unregulated arm. This would ensure consistency both with the current market, and for consumers of solicitors' services, whether received through ABS or traditional firms, and would ensure that there was a level playing field between different types of firm.

56. A risk based alternative might be to allow ABS more flexibility subject to demonstrating how they would ensure consumers understand that where unreserved services are provided through an associated unregulated company they are beyond the regulatory reach of the LA. Whilst permitting consumers a wider choice, the ability to provide "split services" would need to be backed by comprehensive transparency provisions so that consumers can understand which of the services they receive are regulated and the effect of that to allow an informed choice of provider. A means of adequately measuring transparency for consumers would be important and need some consideration.

57. Of these alternatives, we currently favour the former option, since the risks to consumers are the same, whether the entity is a traditional law firm or ABS. We would like to discuss this issue further.

b. Should all legal activities undertaken by an ABS be regulated or just reserved legal services?

58. Our view is that if ABS deliver regulated legal services under an identity or "badge", then all legal services under that badge should be regulated to avoid the risk of consumers being misled. We would also want to ensure that protected titles such as "solicitor" are not used to mislead consumers in an unregulated environment.

59. We note paragraph 170. Outsourcing of legal and non-legal services has developed relatively freely in the current market with little intervention by the SRA. We agree with the principle of outsourcing subject to the regulated firm remaining at all times responsible for the activities of the outsourcer, which

brings with it the necessity to monitor outsourced activities to ensure that the desired outcomes are being achieved.

c. What role do you see consumer education playing?

60. Consumer education has an important role, particularly given the increasing diversity of legal services providers in the legal marketplace. Consumers need to be aware of the choices available to them and the implications for them of those choices. As a starting point, we agree that there is a need for research on how well consumers understand the current situation.

61. Consumer education does of course present significant challenges and must be a long-term initiative, involving the LSB and all LAs. In the longer term, it will assist in, but not remove, the asymmetry of information between consumers and legal services providers; it therefore needs to be complemented by clear information from legal services providers about the nature of those services, and the rights and obligations of consumers when receiving those services.

d. How should ABS which are part of a wider group of companies be treated?

62. We refer to views earlier in this section, particularly regarding transparency.

63. If there is to be a high level outcome that those in an ABS have a duty to ensure that consumers are not confused about whether services which appear to be legal services are regulated or not, then an ABS should be under a duty to ensure consumers understand the nature of their various services, and the identity and regulatory status of the entity providing those services. An option is for LAs to require, as part of the process for application/renewal of a licence, to set out how this will be achieved. The SRA also intends to include outcomes in its Code relating to the need to provide clear information to clients on services provided.

5. Are the enforcement powers for LAs suitable?

a. What is your view on the proposed maximum level of financial penalty that a LA can impose on an ABS?

64. We broadly agree with the proposals for enforcement. An unlimited power to fine, subject to the normal constraints, is appropriate and not uncommon.

65. However, we would prefer to have equivalent powers to fine all firms that we regulate, albeit we will do so in different regulatory capacities. Inconsistency in relation to fines for conduct (in contrast to administrative fines) could mean, for example, that we are restricted in our ability to impose the same sanctions for the same behaviour purely because firms are of a different type. This might be difficult for the public to comprehend and affect the reputation of the regulatory system. It may also lead to a perception of unfairness among those who are regulated.

b. If you do not consider the proposed maximum to be appropriate what amount or formula would you propose?

66. See above.

c. Will LAs have sufficient enforcement powers?

67. Currently we have a range of enforcement powers and mechanisms for traditional firms and LDPs.

68. We believe that our current powers in relation to traditional firms and LDPs are sufficient in the current market but that with the introduction of ABS, both they and the powers that the Act provides to LAs in relation to ABS may not be sufficiently comprehensive or consistent.

69. We have identified a number of areas where these concerns apply and have discussed some of them with the LSB in the context of discussions about the extent to which an Order under s.69 of the LSA may be appropriate to amend statutory powers to make regulation by the SRA more efficient and effective.

70. We have identified disparities in relation to:

- intervention powers;
- control of non-lawyer managers and employees;
- financial penalties;
- evidence gathering powers relating to third parties;
- recovery of costs.

71. We are in the process of putting together a detailed analysis of these issues, and intend to complete that analysis in the light of the LSB's helpful Open Letter on s.69 issues.

72. We would also welcome further discussion with the LSB on the powers for LAs in Schedule 13 of the LSA which deals with the process for objecting to notifiable interests. We are interested, in particular, in the preferred direct enforcement routes if the acquirer and the ABS disregard any objections of the LA, and continue to hold the notifiable interest in circumstances when the divestiture condition or grounds for intervention do not arise.

d. Will ABS have sufficient clarity as to how the enforcement powers may be used?

73. Yes, we believe so. Our concern is that there may be confusion for firms that convert from a traditional model to ABS or vice versa where the powers are different.

e. In what circumstances should a LA be able to modify the terms of a licence?

74. We think the section 86 power will be a useful tool for LAs, particularly when education, encouragement or ordinary supervision prove inadequate at managing risks presented by an ABS.

75. Modification of the terms of the licence may be appropriate where an ABS is found to present a risk in one area, but able to operate effectively in others – the ability to limit the ABS' activities allows a more proportionate response

than use of enforcement powers such as revocation, suspension or intervention.

76. It will also be a useful mechanism to close any enforcement "gaps", such as ensuring that individuals (against whom we do not have disqualification powers but whose links with an ABS are contrary to the public interest) are excluded from the ABS, or limiting their involvement to areas where it is possible to adequately manage the risk.

f. Are there appropriate enforcement options for use against non-lawyer owners?

77. We believe that the enforcement powers available to the SRA under the section 43 Solicitors Act are more effective – they are wide enough to cover a person involved in a legal practice who has or intends to acquire an interest in a recognised body. The LSA lacks an equivalent power to control the involvement of non-lawyer owners of ABS.

6. What do you think of our approach to access to justice?

a. Do you think the wide definition to access to justice that we have taken is appropriate?

78. This seems appropriate.

b. Is asking an ABS on application how they anticipate that they will improve access to justice a suitable approach?

79. We agree that LAs should take this approach to help take account of the objective in the Act of improving access to justice. Our concern is how and to what extent this will affect the LA's decision when considering the application. Is it sufficient that this is a means of raising awareness? If the aim is to achieve some more practical outcome than simply raising awareness, it would be helpful to have further discussions on how LAs might be approach this in assessing some, if not all, applications.

c. Do you agree that restrictions on specific types of commercial activity should not be put in place unless there is clear strong evidence of that commercial practice causing significant harm?

80. Generally, yes. The judgement should be made on the nature and extent of the apparent risk. If LAs believe there is clear evidence of a high likelihood of causing harm, consumers' interests are likely to be better protected by proportionate prevention, rather than waiting for evidence that the anticipated harm had been done. Restricting LAs too tightly, so that they are unable, when assessing applications, to rely on previous experience as a regulator, may prevent their complying with the regulatory objectives overall. A proportionate and risk-based approach at the outset is desirable.

d. Do you agree that LAs should consider how ABS in general impact access to justice rather than trying to estimate the impact of each application singularly?

81. Yes. However, it would be almost impossible for any single LA to do so in isolation because each will be familiar with only a part of the market. If this

type of assessment is to be undertaken it needs to cover the whole market and is likely to be unreliable if it did not. We believe that Parliament envisaged LAs having the ability to make an assessment in a single case but we think this is likely to be very rare. We agree that this should not be part of most normal licensing applications.

e. Do you agree that LAs should monitor access to justice?

82. We believe that it would be sensible for the market as a whole to monitor access to justice and that individual LAs will have a role in that.

7. What is your view of our preference for a single appeals body?

a. Should, in the future, a single body hear all legal services appeals?

83. We think this idea has considerable merit. Our comments relate to timing and the nature of appeals to be heard.

84. At the commencement of ABS, we believe the new tribunal should only hear appeals of a licensing and administrative nature. If the new tribunal were to deal with ABS matters such as licensing appeals, HoLPs, HoFAs and so on, this would facilitate consistency for all types of ABS, and assist the tribunal in developing a uniform and reliable approach. In disciplinary or conduct matters, where we think there is an overriding need is for consistency between traditional firms and ABS, we propose a continuation of the existing disciplinary tribunals until all such matters can be transferred to a single body.

85. We recognise that such an interim solution may not have been envisaged by the statute but consider that the benefits of such an interim approach warrant careful consideration.

b. If you do not think there should be a single body, who should hear appeals from LSB decisions should it become a LA?

86. Please see above.

c. Is the GRC an appropriate body to hear appeals?

87. We need to understand more but at first sight this sounds sensible.

d. What other options for the location of the body?

88. We have no comment to make.

8. Do you agree with our approach to special bodies?

a. Do you think that special bodies' transitional arrangements should come to an end?

89. Yes.

b. Do you think 12 months after the start of mainstream ABS is sufficient time for them to gain a full licence?

90. Although 12 may be sufficient we believe that a period of 12-24 months might be more realistic and allow LAs to benefit from the experience to be gained from the first wave of ABS.

91. The more urgent issue for the LSB, the Ministry of Justice and LAs is the current lack of clarity over the range of bodies that might fall within the "special bodies" regime. This has a direct impact on the SRA's ability to write outcomes and rules for in-house solicitors.

92. The question of whether "not for profit" bodies need to be licensed when the transitional period ends depends on whether they provide reserved legal services to the "public or a section of the public". It is unclear from the Act who falls within this definition. Local authorities provide an illustration of the difficulties this presents. Given the expansion of local authorities' powers in the "enabling" legislation of the last decade, the full range of individuals and organisations for which local authorities now act may be enormous, and it is likely that some will constitute "the public or a section of the public". This problem could be replicated across a range of public and voluntary bodies.

93. If local authorities (for example) had to be licensed, the SRA would hope that (assuming local authorities are not for profit bodies) it would be able to modify its rules appropriately and proportionately, and produce a relatively relaxed regulatory regime. (The SRA already has special rules for local authority solicitors – see rule 13.08 of the Solicitors' Code of Conduct 2007.)

94. Alternatively, local authorities (and others) might seek to persuade the Lord Chancellor to make an order under section 15(9) LSA exempting them from authorisation or licensing permanently. This would raise important policy issues upon which the SRA would expect to be consulted.

95. We look to the LSB and the MoJ to clarify the legal position as soon as possible.

c. Do you think LAs should adapt their regulation for each special body?

96. We think it is likely to be too costly for LAs to have a completely "open" approach to special bodies that would allow infinite options and we would be concerned that such an approach would lack transparency. However, as we think these bodies are likely to fall into a number of identifiable categories such as Law Centres, LAs could perhaps offer a suite of adaptations for which special bodies could apply.

d. Do you agree there are some core requirements that all special bodies should meet? If so, what do you think these are?

97. We believe that special bodies should be dealt with in largely the same way as other ABS but that a proportionate approach is needed, based on our understanding of the risks posed. Our thinking in this area will need further work.

e. What are your views on the suggestion that the OLC should make voluntary arrangements with special bodies?

98. This seems to be a good idea if it is possible and would contribute to consistency for the consumer.

9. Do you think that our approach to HoLP and HoFA is suitable?

99. The HoLP and HoFA are key safeguards in the legislation. Minimum outcomes must be that they are competent to fulfil their roles in the ABS in which they work, and have sufficient authority.

100. One option might be to develop suggested high-level core competencies and key result areas in relation to these roles, to help ABS to recruit those with suitable skills and experience. These would not be imposed, but could be adapted by firms to their particular needs and circumstances. It might be that the Law Society, in its representative, capacity could produce model job descriptions.

a. Do you think that our approach on focusing on compliance systems across the organisation is suitable?

101. Yes. We agree with the thrust of the paper regarding the importance of governance requirements. We would like to know whether the LSB has any particular views on governance. We would consider it appropriate for some of the detail on governance arrangements to be worked through by LAs. As we see it, the crucial issue for the HoLP and HoFA is that they have the necessary authority to influence, monitor and enforce (as necessary) high standards of compliance, including ensuring that potentially competing or conflicting commercial interests do not impact the professional principles and the achievement of outcomes.

b. Do you think that HoLP and HoFA should undergo a fit and proper test?

102. Yes. The HoLP must already be an authorised person, and will have had to fulfil the basic requirements of the fit and proper test. The HoFA, on the other hand, may not be an authorised person and so should be subject to the test, possibly including a declaration in relation to spent convictions.

c. Should there be training requirements for the HoLP and HoFA?

103. Yes, but not in the form of prescriptive requirements: we consider that guidance about these will be of sufficient assistance to ABS, who must determine for themselves what is appropriate given the nature, scale and complexity of their business.

104. We are also, through our “agenda for quality” programme, looking at setting out the competencies expected of different roles within law firms, and are considering including competencies for HoLPs and HoFAs in that work.

105. With regard to minimum requirements for HoLP, we think it would be realistic for the applicant to show experience of dealing with compliance and regulatory issues at senior level (bearing in mind the need for any test to be flexible and proportionate for all sizes and types of firm). We do not think

that the experience should be confined to private practice. We would welcome further discussion with the LSB over our developing approach.

d. Do you agree that the HoLP and HoFA could be the same individual (especially in small ABS)?

106. Yes. This will be very important if small, "high street" multi-disciplinary ABS (e.g. consisting of a solicitor and a surveyor) are to develop.

10. Do you think that our approach to complaints handling is suitable?

a. Do you think that ABS complaints should be handled in the same way as non-ABS complaints?

107. Yes. We agree that consumers will benefit from a consistent approach. We believe this can be achieved through high level outcomes.

b. Do you think that ABS should be allowed to adapt their complaints handling systems if they already have one for their non-legal services consumers?

108. Yes, if the adapted systems meet the outcomes and requirements of our Code for the fair treatment of consumers.

c. Do you think it is appropriate for the OLC to take complaints from multi-disciplinary practice consumers and refer where necessary?

109. We believe that ABS should be required to signpost to consumers the appropriate organisation(s) to approach with complaints about particular services, with the OLC providing, in effect, a backstop role only when that system fails.

11. What are your views on our proposed course of action to conduct research and, depending on the results, either compel transparency of data or encourage it?

a. Do you agree with our position on diversity and ABS?

110. Yes, this accords with the SRA's strategy on inclusivity and our desire to actively promote equality and diversity in the way we undertake all our activities.

b. Do you agree that the overall impact is unlikely to be adverse to the diversity of the profession?

111. We agree, but will continue to monitor any potential for adverse impact.

c. Do you agree that non-lawyer managers may open new career paths to lawyers and these may have a positive impact on career progression?

112. We have always supported the development of ABS as a way of facilitating different career paths, which should have a positive impact on equality and diversity.

d. Do you agree that the demand for diverse legal professionals will, largely, offset the potential impact due to the closure of small firms?

113. It is difficult to speculate. This is something which will need to be monitored.

e. Should the LSB require information about the diversity of the workforce in ABS? If so when and should this be a requirement for other legal service providers?

114. We agree that this should not initially be a requirement on all, and that the right approach should be developed with the benefit of experience. We agree that in principle the same approach should apply to ABS and other legal service providers. We might predict that the right outcome may be to make some differentiation between large and small businesses.

12. Do you agree with our approach to international issues?

115. We agree with your approach and that ensuring an understanding of how the ABS regime delivers appropriate regulation will be important. There may still be a number of unresolved international issues which were not fully developed in the Act and which need further thought. For example, should we be able to regulate the overseas activities of an ABS in jurisdictions where they would be allowed to operate. How would we deal with international firms (based overseas) providing legal services into the UK? There is also an issue around the SRA's current "regulatory reach". We now apply our rules to solicitors practising overseas and have established that we have that "regulatory reach". So solicitors have been struck off in relation to their activities when practising entirely abroad, and there have been other cases where, for example, compensation fund payments have been made to clients who have suffered loss where solicitors have been practising abroad, even where the clients are themselves overseas.

13. Should LDPs, Recognised Bodies and other similar firms have transitional arrangements into the wider ABS framework in the way we propose?

116. Yes, we think it is appropriate to have a transition arrangement for the reasons identified. We do need more clarity on the proposal, so that we can work out what it means in practical terms. In particular will the enforcement provisions in the LSA make sense set against the current regulatory framework for LDPs?

a. Is 12 months after the start of mainstream ABS sufficient time to allow this to happen

117. Probably, or perhaps 12-18 months. It will be easier to judge the right time when the detailed framework for licensing ABS becomes clearer.

14. Should ABS licences be issued for indefinite periods?

118. We support the proposal for "lifetime" licences. It would reduce the burden for both LAs and firms and is in line with the practice of regulators in other sectors.

119. However, it must be clear that LAs can set general information requirements (as part of a periodic return) as being essential to risk based regulation. This would need to be linked with penalties or fines for failure to provide the necessary information or accompanying regulatory fees.

a. Should the annual charging process be broadly cost reflective or a fixed fee?

120. We think that the Framework Services Directive requirement for cost reflection applies to application fees where the fee is to cover the cost of application. This does not apply so much where a regulator is seeking annual fees to cover the general cost of regulation. In this latter case other factors such as turnover are a fair reflection. The annual charging process cannot really take likely cost into account. For further elaboration on this point please see our and other regulators' consultation papers on fee structures. We, therefore, think that the annual charging process should be neither cost reflective (except application fees) nor a fixed fee, but a fair way of allocating the cost of regulation among the regulated community.

b. How should LAs ensure ABS are continuing to comply with their licence requirements?

121. We intend to address this issue in detail in our OFR Roadmap publication in May, which will set out how the SRA intends to supervise all firms, including ABS, based on its outcomes-focused approach The paper will also include our approach to enforcement. The SRA intends to develop a number of regulatory tools in order to enable us to assess whether ABS are continuing to comply with licence requirements. These will include assessment of information provided by firms on a periodic basis, risk-based visits to firms, and review of data received from other bodies.

122. In relation to paragraph 349, we are concerned at the suggestion that judicial review will provide a suitable route for what will be one of the most important decisions the LA will make, and one of the decisions with the highest impact on the ABS' ability to practise. We believe that these discussions will be better dealt with by the appellate body.

15. Do you agree with our approach to managing regulatory overlaps?

a. Is it desirable to have a framework approach to a MoU?

123. We agree with the approach.

b. Do you think we have identified the right bodies to develop a MoU with?

124. There are likely to be many more but those identified are a suitable starting point.

c. Do you think we have identified the right issues to include?

125. Additional issues include client money rules, professional indemnity and compensation fund arrangements, and the use and extent of the reach of enforcement powers such as intervention.