

To:	Legal Services Board	Agenda Item No.:	Item 6
Date of Meeting:	18 January 2017	Item:	Paper (17) 02

Title:	Identifying the benefits and risks associated with the changing shape of legal services regulation
Workstream(s):	Performance, evaluation and oversight
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Status:	Official

Summary:

The Board has previously considered papers on the emerging market in authorisation, and in particular the growth in opportunities for legal services providers to choose their regulator. (January 2016 and July 2016). Following the Board's discussions on this topic, this paper reports on the findings of a short review of the impact of legal services providers switching between different regulators.

The review's findings indicate that there are relatively low levels of switching by providers between legal services regulators. Where switching does occur, reports indicate that it is driven by various factors including variation between the regulators (regulators' style and approach and obligations imposed on providers relating to protection of consumers' financial interests). To encourage switching, and to help manage exit from the regulated market, some regulators have been exploring and changing their arrangements around one aspect of financial protection requirements: run-off cover insurance. Prevailing requirements have been identified as a barrier to switching (and to exit from the market).

We have been reassured, largely by the small scale of activity, that this is not an area which presents any major concerns at the moment. The review also sought to identify whether more in-depth review was needed to address emerging risks. The analysis has indicated this is not needed at this time but it has suggested areas for possible future work that would seek to manage the chance that protection of consumers' interests could be undermined by this feature of legal services regulation. Any decision to undertake further work should be informed by intelligence collected through ongoing monitoring activity in key areas. The paper recommends a number of monitoring activities.

Recommendation(s):

1. The Board is invited to note the findings of this review and to agree to ongoing monitoring activity to inform any future decision on related areas of work (paragraph 23).

Risks and mitigations**Financial:** N/A**Legal:** Legal analysis on the relevant safeguards in the Act has been completed.**Reputational:** There is a risk that the LSB's role and responsibility to oversee the approved regulators may be misinterpreted, damaging the LSB's reputation. This can be mitigated through clear and consistent communications about the extent of the LSB's statutory responsibilities and powers to act.**Resource:** The ongoing monitoring described in the paper will require some resource. If any of the potential further work is required this will need to be fully scoped and may require substantial resource.

Consultation	Yes	No	Who / why?
Board Members:	x		Helen Phillips
Consumer Panel:		x	N/A
Others:	N/A		

Freedom of Information Act 2000 (Fol)

Para ref	Fol exemption and summary	Expires
Paras 4-6, Para 12-14, 16-25. Annex A: Paras 4-6, 8 Annex B: Para 8 Annex C	Section 36(2)(b)(ii): information likely to inhibit the exchange of views for the purposes of deliberation	

LEGAL SERVICES BOARD

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Identifying the benefits and risks associated with the changing shape of legal services regulation

Recommendation

1. The Board is invited to note the findings of this review and to agree to ongoing monitoring activity to inform any future decision on related areas of work (paragraph 23).

Background

2. The Legal Services Act 2007 (the Act) permitted significant developments in how legal services are regulated in England and Wales. The Act enabled the extension of reserved activities, the designation of new approved regulators, and the designation of new licensing authorities. A number of these options have been taken up and there are now more regulators designated to regulate more activities and more business models than when the Act was commenced.¹ A result of this is that some legal services providers now have a choice of regulator.
3. While permitted and enabled by the Act, none the less having a choice of regulator is unusual in statutory regulation. As the opportunity for competition emerges between regulators and providers are able to take advantage of the differences in authorisation, supervision and enforcement, there is the potential risk of 'regulatory arbitrage' and consumer confusion. Previous LSB thematic reviews have identified points of difference between regulators on specific issues, for example sanctions and appeals² and insurance options³.
4. [REDACTED]

¹ January and July 2016 Board papers on the emerging market in authorisation included a table on the extent of legal services regulation: 2010 vs current. This set out the provisions when the Legal Services Act 2007 came into force (2010) versus current opportunities to authorise. The table will be available at the Board meeting if members would like to see it.

²http://www.legalservicesboard.org.uk/projects/thematic_review/pdf/20140306_LSB_Assessment_Of_Current_Arrangements_For_Sanctions_And_Appeals.pdf

³ http://www.legalservicesboard.org.uk/Projects/thematic_review/Choice_Of_Insurer.htm



5. [REDACTED]

[REDACTED]

7. Given this context, the Board agreed to undertake a review of current switching activity and to identify whether there was evidence of risk that would require more detailed analysis of specific topics or issues. This paper reports on the findings of this review and makes a number of recommendations for future monitoring activity.

Our review and key findings

8. There are different scenarios where switching between regulators may occur in legal services. These include:
- (a) switching by individual providers
 - (b) collective switching by regulated communities
 - (c) regulators targeting regulated communities in non-traditional markets (a regulator who previously was not the main regulator in the conveyancing market, for example, attempting to be the main regulator in the market)
 - (d) regulators targeting an unregulated community (for example, a regulator targeting the will writing market)
9. We consider outcome (a) the most likely to emerge and the only one there are clear examples of at this time. For this reason, while we have considered general issues that apply across all of these possible outcomes, the focus of this project has been on individual legal services providers being able to switch regulators.
10. Our work has focused on identifying the main points of difference between the regulators and from this, the areas where more detailed review may be needed to assess risks arising from the increased opportunity for regulator switching. We

have spoken to all of the entity regulators⁵, the Legal Ombudsman, the Claims Management Regulator (CMR)⁶ and the Office of the Immigration Services Commissioner (OISC)⁷. We have also spoken to a small number of providers about their experiences of switching regulators. These discussions have helped us to gauge the scale of current switching activity, the processes and procedures in place to manage regulator switching, and any emerging concerns.

11. A summary of our findings on the main points of difference between the regulatory approaches of the five entity regulators can be found at Annex A. For those providers who do switch regulators the main determining factors have been identified as follows:

- the ease and time-taken to be authorised
- the professional indemnity insurance requirements whilst practising
- compulsory run-off cover when exiting regulation.

12. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

⁶ The CMR regulates about 1,500 businesses that deal in personal injury and financial claims. There is some cross-over between claims management regulation and legal regulation in relation to personal injury claims.

⁷ The OISC regulates immigration organisations and advisers. To give immigration advice (in England and Wales) you must be licenced by the OISC or be a member of the Law Society, the Bar Council or the Chartered Institute of Legal Executives. The OISC regulate about 1,600 entities.

[REDACTED]

- The CMR reported that a small number of businesses have switched from the CMR to the SRA. The CMR believes the main motive for switching is referral fees. In 2013 the Ministry of Justice put a full ban on referral fees for personal injury claims, following this up to 20 businesses switched to the SRA. The CMR reported it has a close relationship with the SRA and they meet quarterly to discuss issues and emerging risks. The CMR confirmed that the SRA contact them when relevant businesses switch to them and ask for any appropriate information.
- The OISC exit survey of entities found that of the 68 entities who left OISC authorisation in the preceding six months⁹, three entities had switched to the SRA or BSB. OISC identified a risk where individuals under its regulation, who are being disciplined or investigated, change firms to work under the supervision of a barrister or solicitor, but it suspects the numbers are very small.
- The Legal Ombudsman does not collect data on the frequency of complaints about firms where they have switched regulators. While it has dealt with some complaints in this area, these have been very infrequent. It is not aware of any inconsistent standards between regulators or any emergence of firms moving between regulators in order to avoid detection or enforcement.

15. Other organisations have also commented on this topic:

- In its 2013 report on financial protection arrangements and in recent responses to consultations from the SRA and the CLC on amendments to run-off cover, the Legal Services Consumer Panel (the Panel) suggested regulators need to work together to avoid creating consumer detriment as they help providers to switch, and work towards establishing a consistent or single set of compensation arrangements.
- The CMA commented on competition between regulators in the final report of its legal services market study. They noted that there is a risk of regulators seeking to gain members by reducing regulation to an inappropriate degree. However, they also noted that competition could encourage regulators to become more efficient and proportionate and could incentivise best practice.

16. According to regulators, the main reason for the low rate of switching is the barrier of professional indemnity insurance (PII) run-off cover.¹⁰ The Board may recall CILEx Regulation's report (Dec 2015) on this topic.¹¹ The CLC and the SRA are taking steps to address this barrier and more information on this work is included in Annex B.

17. The CLC has recently altered its arrangements to include free run-off cover at the point of closure of an insured entity.¹² In April 2016 the SRA consulted on

⁹ Between April and September 2016

¹⁰ The premium for run off cover will vary depending upon the facts of each case but is typically around three times the annual premium.

¹¹ http://www.cilexregulation.org.uk/~media/pdf_documents/cilex-regulation/reports/report-to-lsb-restrictions-created-by-run-off-insurance.pdf?la=en

¹² <http://www.conveyancer.org.uk/Regulation-by-CLC/Professional-Indemnity-Insurance.aspx>

proposals to amend its approach to run-off cover.¹³ [REDACTED]

[REDACTED]

18. [REDACTED]

[REDACTED]

19. [REDACTED]

[REDACTED]

[REDACTED]

¹³ <https://www.sra.org.uk/sra/consultations/removing-barriers-switching-regulators.page#download>

[REDACTED]

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Recommendation

26. The Board is invited to note the findings of this review and to agree to ongoing monitoring activity to inform any future decision on related areas of work.

09.01.17

Comparison of major points of difference between the entity regulators in the legal sector

1. As mentioned above, we have looked at the different regulatory approaches taken by the regulators to see what differences might lead legal services providers to choose one entity regulator over another. A table summarising key high-level information about each regulator was produced and was fact-checked by the entity regulators.
2. It should be noted that the regulators and the communities they regulate are all of different types and sizes. The comparisons below are high-level only and do not take these differences into account. They may not always be a like-for-like comparison.

Entry

3. All regulators ask for the same core information from an applicant including organisation structure, the names of the senior managers, information about insurance arrangements and some form of business plan and governance arrangements. There is however a difference in the time taken by regulators to authorise new entities.

4. [Redacted]

Compliance

5. [Redacted]

6. [Redacted]

7. All regulators set minimum levels of PII and most have agreements with the insurance industry to set up panels which its members must use.

8. [REDACTED]
9. The minimum level of cover affects premiums and entities the most. For the SRA, CILEx Regulation and CLC minimum cover is £2m per claim, BSB and ICAEW require £500k per claim and IPReg £250k in the aggregate.
10. Five of the regulators have a compensation fund. The BSB does not as their members cannot hold client money. Maximum grant levels are set by the schemes. The SRA's scheme has a maximum grant of £2m, CILEx Regulation's is £500k, IPReg's is £25k and ICAEW has a limit of £500,000 per estate.
11. Regulators charge application, authorisation and annual fees to the entities they regulate, these are however difficult to compare due to the different charging structures used. The SRA and CLC charge based on a percentage of the firm's turnover. CILEx Regulation also charges based on a firm's turnover, but uses different rates for different firms depending on if/how they hold client money. The BSB and IPReg charge fees based on the number of authorised people at the firm. ICAEW also charge fees based on the number of authorised people at the firm, but also take the number of offices into account.

Exit

12. When an SRA or CILEx Regulation firm closes they have to pay a PII premium for six years run-off cover. ICAEW firms must have two years run-off cover, six years is recommended. IPReg does not offer any guidance on run-off cover.
13. CLC regulated firms do not have to pay this premium, as the CLC has agreed that run-off cover is included at no extra cost for firms under their Participating Insurers Agreement. This is a recent change to CLC's arrangements and the impact is not yet known. BMIF members get run-off cover up to £500,000 when they stop practising.
14. Currently firms are regarded as closing even if they continue to practice under a different regulator. This has been identified by regulators as a major barrier to switching regulator. The SRA are currently investigating this barrier and are talking to other regulators and insurance providers about solutions for firms that wish to switch regulators.

Run off cover developments in the legal sector

Current status and impact of the CLC and SRA consultations on relevant financial protection arrangements

Both the CLC and SRA have recently consulted on changes to their run-off cover requirements. The consultations have considered the impact of their arrangements on the ability of firms to switch regulator.¹⁵ The developments are discussed below.

CLC

1. In May 2016 the CLC consulted on changes to its indemnity framework, with proposals to move away from its Master Policy arrangements and instead allow CLC regulated entities to choose from a pool of insurers who have signed up to a Participating Insurer's Agreement.¹⁶ The only significant difference between the PII terms in force and the proposed arrangements related to run off cover. Under the new framework insurers would include six years run off cover at no additional cost to CLC entities at the point of closure.
2. The LSB approved the changes proposed by the CLC and these took effect from 1 July 2016 with two insurers signing up to the Participating Insurer's Agreement. The CLC completed a review of its 2016 PII renewal round which operated under the new PII arrangements.¹⁷ This found the process to have run smoothly and that the majority of entities were happy with the changes to the arrangements and satisfied with the process for obtaining PII.
3. Information provided by insurers also showed that overall, premium rates were low by historic standards and the addition of run-off cover free at the point of closure of an insured entity, had not led to an increase in premium rates. The CLC believes though that it has greatly enhanced consumer protection, reduced the potential exposure of the Compensation Fund and removed what had been a barrier to the orderly closure of some practices in the past.
4. The CLC believes the inclusion of run off cover should also remove this as a barrier for CLC firms who wish to move to a different regulator. Any firm moving to the CLC would be required to obtain PII from an insurer who has signed up to the Participating Insurer's Agreement, in addition to being subject to the CLC's normal due diligence ahead of authorisation to provide conveyancing or probate services (as well as other related non-reserved activities). Run off cover would however be required in relation to any other legal services, or a separate appropriately regulated entity, which continues to provide those services, would be needed.

SRA

5. In April 2016 the SRA published a consultation on removing barriers to switching regulators.¹⁸ Currently if an SRA firm switches to another legal services regulator it is treated as if it has stopped practising. That leads to the

¹⁵ The premium for run off cover will vary depending upon the facts of each case but is typically around three times the annual premium.

¹⁶ <http://www.conveyancer.org.uk/Regulation-by-CLC/Professional-Indemnity-Insurance.aspx>

¹⁷ http://clc-uk.org/CLCSite/media/Research-Reports/20160728-PII-Renewal-2016-Review_1.pdf

¹⁸ <https://www.sra.org.uk/sra/consultations/removing-barriers-switching-regulators.page#download>

requirement for six years of run off cover being triggered even if the firm takes out PII for its future business which also covers claims arising from client matters that concluded over the previous six years (while authorised by the SRA).

6. The obligation to ensure run off cover is in place is placed on the firm and the insurer through different mechanisms: the SRA indemnity insurance rules 2013 and the participating insurer's agreement. Requests have been received by the SRA, in relation to this obligation, from both the firm wishing to move to another legal services regulator and by the regulator they wish to move to. The SRA however only has the power to waive the obligation on a firm and this does not alter the obligation on the insurer under the participating insurer's agreement. The proposals in the SRA consultation seek to remedy this situation.
7. The SRA consultation notes a potential risk that competition between regulators may indirectly lead to outcomes that are not in the public or consumer interest (if regulators reduce consumer protection below an optimal level to attract firms). It highlights the LSB's role in approving the adequacy of each regulators regulatory arrangements, which includes that their arrangements adequately consider the appropriate levels of consumer protection that apply when a firm switches, in particular cover for client matters concluded before the switch. The SRA stresses that the appropriateness of such arrangements will be for each regulator, again subject to the approval and oversight of the LSB. This explanation suggests a potential misunderstanding of our role, in particular a misapprehension about the extent of our powers to deliver consistency across the regulators.
8. [REDACTED]

[REDACTED]