

To:	Legal Services Board	Agenda Item No.:	12
Date of Meeting:	28 April 2017	Item:	Paper (17) 29

Title:	Research into barriers to investment into legal services
Workstream(s):	Breaking down the regulatory barriers to competition, innovation and growth (see LSB Business Plan 2016/17)
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Status:	Official

Summary:
This paper presents an overview of the findings of the LSB's research into barriers to investment in legal services, seeks the Board's comments on the executive summary of the research report, and updates the Board on our communications plans around publication of the report in May.

Recommendation(s):
The Board is invited to: <ol style="list-style-type: none"> Note the key messages arising from the research; and Review and comment on the summary report in Annex A. <p>In line with the Schedule of Delegations, and pending discussion of this paper, the Chief Executive will approve the final materials for publication.</p>

Risks and mitigations	
Financial:	Low. No significant financial risks are identified.
Legal:	Low. Legal advice was sought on the draft report and we have followed this advice in redrafting (To be done)
Reputational:	Medium. Our findings will generate interest among representative bodies, regulators, academics, the CMA, and MoJ. They may challenge our interpretation of the evidence. To mitigate this risk we held two workshops with representatives from the legal and financial industries to guide our approach to the research and discuss our findings. A communications plan and press lines will be prepared to accompany publication of the report.
Resource:	Low. No significant resource risks are identified.

Consultation	Yes	No	Who / why?
Board Members:	x		David Eveleigh – Board lead for this project.

Consumer Panel:		x	N/A
Others:	We held two workshops with representatives from the legal and financial industries to talk through our approach to the research project and to discuss findings. The report reflects the outputs of these discussions.		

Freedom of Information Act 2000 (Fol)		
Para ref	Fol exemption and summary	Expires
Annex A	s.22 (future publication)	

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Recommendation

The Board is invited to:

- (1) Note and discuss the key messages arising from the research;
- (2) Review and comment on the summary report in Annex A

In line with the Schedule of Delegations, and pending discussion of this paper, the Chief Executive will approve the final materials for publication.

Background

1. As set out in our 2016/17 business plan, the LSB wishes to continue to ensure that regulation does not unnecessarily deter entry, innovation and investment. As part of this, we committed to analyse investment in the legal sector, to identify current sources of capital and establish how the investor community views the market and any barriers to investment. This report presents the results of our research, which in particular aims to assess whether there are any regulatory barriers to investment in legal services.
2. Our Market Evaluation shows slow change in outcomes associated with increased competition and a lack of evidence of improving access to legal services. It also demonstrates the collective lack of information about investment in the sector and the views of potential investors. This research begins to fill this knowledge gap.
3. A major aim of the permitting of new business structures was to allow new forms of capital into regulated law firms to improve market efficiency. Prior to 2009, non-lawyer partnerships were prohibited, although some forms of non-lawyer ownership were permitted under CLC regulations. Regulatory restrictions meant that capital for a solicitors firm could only come from existing partners taking on more debt individually, admitting new partners to the business and ceding some element of control, or the business taking on a loan or a larger overdraft facility. Therefore enabling external investment in law firms was designed allow less reliance on short term sources of financing such as personal debt and overdrafts.
4. The expectation was that the admission of new capital would increase competition and reduce the cost of legal services, to the benefit of the regulatory objective of access to justice. The economic theory behind this is, broadly, that capital enables scale of delivery and development of services – perhaps through

investment in technology or branding - and that scale would reduce costs. In turn reduced cost will improve access to legal services translated through lower prices, as cost – perceived and actual – is a key barrier to accessing legal services for individuals and small businesses. Other research commissioned by the LSB shows continued high levels of unmet need, for example for the 2014-2016 period advice and assistance was obtained in only 30% of issues.

5. In addition to new capital, it was also hoped that investors might bring new ideas about how legal services might be provided in consumer friendly ways. By introducing different perspectives into the ownership of regulated legal businesses, these business would start to innovate.
6. Given the research aims, our analysis draws from a variety of strands of evidence. We sought to gather information from investors, regulators, ABS, and traditional firms. Fieldwork and literature reviews were undertaken from October 2016 to March 2017. This included our review of work by Leeds University into ABS, a summary of which was circulated to the Board in September 2016.

Findings

7. Our research shows encouraging evidence of the increased scale and diversity of ownership of law firms that the Legal Services Act reforms were designed to enable. The majority of ABS firms (66%) either have already invested in their businesses or are planning to do so, by hiring more staff, increasing marketing activity and purchasing IT. Over a third of ABS are majority owned by non-lawyers, while those with higher levels of non-lawyer ownership are more likely to invest in their businesses.
8. Our research also shows ABS firms accessing a wide range of sources of finance, and only a small proportion indicating difficulties in accessing finance. However, only 12% of ABS we surveyed had used any form of external equity finance. Instead, the most frequent source of funding for investments was business profits or cash reserves (49%), followed by bank loans (29%) and overdraft facilities (27%).
9. Legal services regulation does not appear to be acting as a significant barrier to investment. Only 8% of ABS in our survey indicated that they found regulation was acting as a barrier to them accessing long term sources of finance. The cost of regulation and licensing processes also do not appear to be acting as barriers. Wider changes to business regulations and governmental activity, though, are reported to be having an impact, reflecting the desire from investors for a stable regulatory environment.
10. Instead, non-regulatory factors appear to be the main barriers to external investment. While the overall size of the sector and large number of small law firms may limit opportunities for some investors, cultural and management factors seem to be the main factors. Investors report that law firms are reluctant to seek external investment, and a large proportion of firms are concerned about losing control of the business. There are also concerns about the quality of governance and a view that many firms do not present financial information in the ways investors expect and/or have a weak grasp of the value of their businesses.

11. The draft executive summary of the research report is presented in **Annex A**.

What this means for us

12. Clearly it is not for regulators to judge what the right sort of investment finance is for individual firms. However, in the context of ongoing levels of significant unmet legal need, it would concern us if the potential added benefits of external investment are not being realised due to issues relating to the overall functioning of the market. These benefits include greater scale of investment and injection of new ideas and business disciplines that could enable more transformative change in the sector.

13. The CMA recently concluded that competition in the legal services market is not working as well as it could. Our Market Evaluation highlighted the slow pace of change in the sector, while other research we have done has revealed that levels of innovation are not increasing. Further, investors told us they view legal services as a 'sleepy' market. In fact, this makes the sector ripe for external investment, but only if firms are open to this opportunity. Yet, concerns about weak competition and the findings around use of borrowing for investment suggest that there is currently insufficient impetus for law firms to take the greater risks (and rewards) involved with using external capital.

14. There are some potential signs that there may be greater demand for external investment in the future. These trends include a growth in the proportion of all firms adopting a more corporate structure, and the current trend for market consolidation. However, stimulating increased competition in the market – through the combination of demand and supply-side changes recommended by the CMA – is likely to make the most difference to opening the sector up to greater levels of external investment.

Next steps

15. The Research team will now finalise the report ahead of publication in early May (subject to Purdah). A communications plan and press lines will be developed to accompany this. This will emphasise the lack of any legal services regulatory barriers to investment and the success of the reforms in enabling non-lawyer ownership. A summary of the findings will be shared at the regulatory CEO meeting in early May.

16. Given that there are no substantial regulatory barriers to investment no specific follow up work is planned. Our ongoing emphasis on deregulation and increasing competition is expected to lead to higher levels of external investment in time. Further, we will continue to monitor changes to market outcomes through our triennial market evaluation exercise – next due in 2018/19.