



DEVELOPING REGULATORY STANDARDS

A RESPONSE BY THE INSTITUTE OF LEGAL EXECUTIVES

AND ILEX PROFESSIONAL STANDARDS LIMITED

DISCUSSION PAPER BY THE LEGAL SERVICES BOARD

ON PROPOSED RULES TO BE MADE UNDER

SECTIONS 3, 4 AND 28 OF THE LEGAL SERVICES ACT 2007

29 July 2011

INTRODUCTION

1. This response represents the joint views of the Institute of Legal Executives (ILEX) an Approved Regulator under the Legal Services Act 2007 (the 2007 Act), and its regulatory body ILEX Professional Standards Limited (IPS). The discussion paper was separately considered, in the case of ILEX by a committee comprising the President and Office Holders together with a number of Council members; and in the case of IPS by its Board. The outcomes of those respective considerations were exchanged and as there was no significant difference of opinion between the two organisations, a joint response is tendered. For the purpose of this discussion paper, “we” is used to mean both ILEX and IPS unless the context suggests otherwise.
2. Both ILEX and IPS are committed to the regulatory objectives and the principles of good regulation as set out in the *2007 Act*. Both organisations wish to emphasise, and will make mention of this in more than one place in this document, that higher professional standards are achieved through engagement with the profession and the involvement of members, rather than through remote top down regulation.
3. ILEX and IPS welcome the opportunity to comment on proposals contained in the discussion paper in respect of the Legal Services Board (LSB) baseline approach to regulation and how the LSB intends to review the “Approved Regulators” (ARs) against the proposed standards.
4. Although a joint response is tendered, it should be considered that under *Part 1 of Schedule 4 to the 2007 Act* ILEX is the Approved Regulator in relation to the reserved legal activities: the exercise of a right of audience; the right to conduct litigation; and the administration of oaths. It is imperative that the LSB, as the overarching regulator, works closely with the profession through both the representative body and the regulatory body to ensure that there is sufficient communication on regulatory objectives and developments at appropriate stages.

5. ILEX and IPS have given detailed consideration to the LSB's baseline approach to regulation. Whilst we support a principles-based approach to regulation as proposed, ILEX and IPS are concerned by the apparent inconsistencies between the proposals contained in the discussion paper and the *2007 Act*. At paragraph 26, the LSB expressly states that it expects "*ARs to develop an outcomes focused approach to regulation*". The *2007 Act* does not impose (expressly or by implication) a duty to adopt an outcomes focused regime. The emphasis is on an approach that achieves what is "reasonably practicable". The *2007 Act* strives to maintain a flexible approach so that structures and approaches to regulation can be tailored to the individual circumstances of the AR.

6. We therefore feel it is necessary to consider how the 'Better Regulation Principles' should be applied. ILEX and IPS support these principles, but it is important to remember that some, particularly 'proportionality' and 'targeting', contain a strong element of subjectivity. ILEX and IPS are mindful of the full wording of *s28 (2) (a) and (b) of the 2007 Act* which also has a strong element of subjectivity: not only must the ARs, so far as is practicable, act in a way which is compatible with the regulatory principles, but must also act in a way "*which the approved regulator considers most appropriate for the purpose of meeting those objectives*". As with other sections of the *2007 Act*, the emphasis is on an approach that achieves that which is "reasonably practicable". Both ILEX and IPS support this approach.

7. ILEX and IPS are pleased to note the LSB recognises that ARs have the freedom to design their own regulatory approaches in so far as they are consistent with the above principles set out in the *2007 Act*. This approach is consistent with the view expressed in Parliament during the debate on the *2007 Act*, and in the model for regulation that has been established by the *2007 Act*. For example, it was expressly recognised that the front line regulators "*need to be allowed the freedom to operate effectively within their spheres of operation*"¹.

¹ David Kidney MP HC debate 4 June 2007 c48

8. Similarly, at paragraph 31 of the discussion paper, the LSB proposes that it will be “*asking ARs to be explicit about how the regulatory regime meets the required standards*”. This proposal is acceptable as long as it does not stray from the principle of proportionate regulation: outcomes focused regulation (OFR) allows those providing regulation to show how the outcomes have been met. It is not for the overarching regulator to specify how the outcomes should be met. By analogy, the application of OFR to firms will allow those firms to achieve the outcomes and decide how their firms approach implementation. This is expressed at paragraph 53 of the discussion paper. ILEX and IPS are of the view that the same principle should apply to ARs. Approved Regulators should endeavour to secure the outcomes having regard to the regulatory objectives and decide how best they will achieve this. Are we to assume that under the proposal the LSB expects the ARs to be explicit about how their regulatory regimes meet the requisite standards only as a starting point, with greater flexibility and freedom thereafter? Further clarification is required.
9. It is encouraging to note the LSB recognises that its regulated community is diverse. This diversity represents strength and there is value in continuing to utilise the individual expertise of the ARs. Some ARs, for example patent agents, deal exclusively with other professionals; they operate, in a sense, in a wholesale market and inhabit a niche and highly technical world: contrast this with ILEX or the Solicitors Regulation Authority (SRA). It is important that the proposals have regard to these diverse considerations when applying the OFR approach. Otherwise, through the LSB’s desire to impose consistency over freedom and flexibility, there is a danger of disproportionate regulation by the LSB of some ARs and thereby of their regulated community.
10. ILEX and IPS are very proud of their achievements. In a recent parliamentary debate, ILEX’s approach to regulation was strongly commended: “*ILEX does an excellent job in regulating its part of the profession, and legal executives also do an excellent job in the services*

*that they provide*². It was further recognised that “*ILEX has created opportunities while firmly maintaining high standards of qualification*”³.

11. It is no secret that ILEX as the AR intends to capitalise on its successes by seeking further appropriate “reserved legal activities” for its members. ILEX applies the same robust standards to everything that it does. There is no reason to believe that the same higher standards will not be achieved simply because it is a new regulatory activity.

12. Subject to the above, ILEX and IPS address the questions in the discussion paper in the order that they are raised.

QUESTIONS

Question 1: Do you agree with our analysis of the changing legal services market? Are there other factors that should be taken into consideration?

13. The discussion paper’s analysis of market change appears to have been largely confined to the consumer perspective at the expense of other factors. ILEX and IPS both recognise that consumer friendly outcomes are an important factor but the discussion paper fails to incorporate a more sector specific framework, recognising the diversity of the regulated community. This includes the increase of niche firms, which provide a very highly technical service not only to consumers, but other professionals. One must also remember the recent recession which not surprisingly forced firms to focus on other issues, including the quality of service provision. The recession has also encouraged in-house lawyers to make more use of what they see as a new, business-minded Bar by instructing them directly⁴.

² Baroness Gale HL Deb, 5 April 2011, c1687

³ Barroness Hayter HL Deb, 5 April 2011, c1688

⁴ Recession encourages in house lawyers to instruct “business minded” Bar directly. Legal Futures: December 10, 2010.

14. The introduction of the *2007 Act* has spearheaded significant changes to legal service provision. This has been described as nothing short of “*seismic*” by some commentators⁵ fearing that as many as 3000 high street firms may disappear in the subsequent upheaval. Although posing a serious challenge to traditional law firms, we also view the emerging legal landscape as opening up a wealth of opportunities for those firms and lawyers, including Legal Executive lawyers, who are willing to make the most of the changes. There will be further and greater opportunities for niche practices, combining different legal or professional skills, offering integrated services to both the middle and smaller market clients. Such niche practices face the additional challenge of delivering their professional services at consistently high levels.
15. The implications of these changes should not be underestimated. In effect, the level of competition within the legal services industry has already increased, resulting in wider access to justice and a commercial environment more attuned to developing innovative and cost effective legal services and products. This has been dictated by law firms anticipating and responding to the needs of consumers. An example is the globalisation of the provision of legal services.
16. A new wave of this globalisation was highlighted by the recent merger of Lovells and Hogan & Hartson creating Hogan Lovells. Mergers were also a major contributor to the significant growth in firms back in the 1980s, started by the merger of Coward Chance and Clifford Turner creating Clifford Chance which led to the establishment of the current ‘Magic Circle’ firms in the 1990s.
17. Other factors include the availability of legal helplines as part of legal expenses insurance which is attached to many household policies. Through these services, consumers may take advantage of the availability of legal advice where otherwise they may not have done so.

⁵ Professor Stephen Mayson 'Brave New World: Impact of the Legal Services Act' 2007

18. We should note how changes in regulation have affected the pace of change in legal services. The discussion paper touches on the change made by the Companies Act 1967. There have also been more recent changes to professional conduct rules which have contributed to the pace of change. For example, changes to relevant professional conduct rules now allow firms to enter into referral fee arrangements.

19. The changes within the legal services market have also been a result of law firms anticipating and responding to the needs of their clients. Change on this basis is likely to increase as *the Act* is built on the principle of putting consumers first. The *2007 Act* will transform the ownership and management of existing law firms and introduce new dynamic and diverse competitors into the market.

Question 2: Do you agree with our focus on outcomes focused regulation; risk identification framework; proportionate supervision; and, appropriate enforcement strategy?

20. It is clear why these four areas have been identified as pillars of the modern regulatory model. In relation to outcomes-focused regulation, legal regulators must be clear about what outcomes focused regulation actually means. We could learn from the financial sector where over the last 20 years, principles based regulation has been defined as an integral part of outcomes focused regulation. In actual fact risk identification, supervision and enforcement are all fundamental areas within an outcomes focused regulatory regime. An example of this is the Financial Services Authority (FSA), in its move to OFR it stated that it was all of the following: an 'evidence based', 'risk based', 'principles based' and 'outcomes focused regulator'. Evidence based and risk based regulation epitomise what the LSB now describe as proportionate supervision whereby regulators focus their supervisory resources on matters that pose the greatest risk and only take action where there is an identifiable market failure and the benefits of intervention outweigh the costs.

21. OFR is the overarching regime and within it lies principles based regulation, risk identification, proportionate supervision (risk/evidence based regulation) and enforcement. Each area of regulation is interwoven and, as stated in the discussion paper, form '*part of a jigsaw*'. If any part is missing or defective the whole approach is undermined. At the same time, if OFR is focused on consumer expectations, consumer engagement appears to be another fundamental piece of the jigsaw.
22. It is unclear the extent to which the LSB will focus on those four areas and the implications for ARs. Each AR may have a different opinion and approach to OFR which may result in inconsistencies between regulators when they all move to such a regime. The LSB is advocating OFR as a way to create consistency between regulators and avoid a two-tier system. The *2007 Act* does not require all ARs to be consistent in standards, only that they meet the regulatory objectives. The LSB states in the discussion paper that it recognises that each AR/Licensing Authority will not regulate the same set or range of risks, so the regulatory frameworks must inevitably vary. Uniformity of approach risks diluting the freedom that ARs should have to design their own approaches to regulation (referred to at paragraph 31).
23. It will be interesting to see how the LSB enforce consistency across ARs if each AR takes a different approach to OFR, appropriately focused on those they regulate. Some ARs may be of the view that certain areas of practice should be governed by rules and others by principles and vice versa. It is unclear how much variance will be allowed between different approaches to OFR and whether these inconsistencies will be viewed by the LSB as not meeting the regulatory objectives. The LSB needs to recognise that each AR may form a different assessment of a similar risk due to factors particular to its regulated community.
24. The proposed outcomes focused regulatory model may not be the only way to embrace the regulatory objectives and Better Regulation Principles. The LSB must appreciate the diverse regulated community of Approved

Regulators and that OFR may not be appropriate for every part of the legal sector. OFR is not a requirement in the Act; however by virtue of paragraph 26 in the discussion paper, OFR is expected.

25. At paragraph 35 the LSB expresses the view that self-regulation, which developed as part of a homogenous legal services profession, is not a model designed for competing for consumers in a dynamic market. The LSB has identified that self-regulation focuses on high hurdles for entry and is no longer viable in an increasingly plural legal services market. We are of the view that the LSB should not lose sight of the need for good entry requirements to equip the regulated community to meet outcomes.

26. There should also be recognition of how principles based regulation and outcomes focused regulation has worked in the financial sector. It should be noted that since the credit crunch and failure of Northern Rock, both principles based and risk based regulation lost their allure particularly in the financial sector. Risk based regulation was severely criticised. Criticisms of principles based regulation post crisis included its failure to provide certainty and predictability, and created a regulatory regime in which regulators could act retrospectively. Principles based regulation was also criticised for allowing firms to get away with the minimum level of conduct possible and therefore providing inadequate protection to consumers.

27. There are different forms of regulation and, in fact, different forms of OFR. It would be useful to know whether the LSB considered other approaches to regulation, before it settled on OFR and what was the full rationale for this approach. The trick is to ensure not only that legal businesses are robustly regulated but also to ensure that oversight regulation of the ARs is non-prescriptive and proportionate. The aim should be to enable competition, quality and choice of legal services provision to the consumer.

Question 3 – How do you think that a more flexible and responsive regulatory regime should be developed?

28. The move to OFR has long been presented as a shift from reactive regulation to proactive regulation. Therefore the regulatory regime should be more proactive and forward thinking, rather than responsive and passive. That is not to say that the regulatory regime should not be able to adapt and effectively respond to trends within the regulatory regime.

29. Given the above, a review and analysis of the factors and issues that will influence and affect the development, shape and structure of legal services in the future and beyond should include, but not be limited to:

- The changing needs, demands and behaviour of clients;
- Technological developments;
- The changing regulatory landscape and OFR;
- Alternative business structures (ABS) and the growth of more diverse business models;
- Changing and emerging roles and skills required of individual lawyers and regulated entities;
- Procurement, funding, political, legislative and structural changes;
- The extent to which, if at all, current non-regulated legal services activity should be brought into the scope of regulation; and
- The costs and benefits of expanded regulatory coverage.

30. OFR is viewed as a '*flexible regime*' as it is based on outcomes/principles which are overarching requirements, drafted at a high level of generality, to enable them to be applied flexibly to a rapidly changing market. Furthermore, as the principles contain qualitative terms ('fair', 'reasonable') rather than quantitative terms ('within 5 working days') they are not as rigid and can be applied more generally to various situations. There are fears that OFR can lead to over-zealous enforcement action being taken by regulators leading to a deterioration of the relationship between the regulator and regulated.

31. 'Flexible' and 'responsive' should describe the relationship between the regulator and regulated whereby the regulator is responsive to the needs of different firms and flexible in order to ensure balance between supervision and enforcement. In order to achieve this there needs to be a change to the mindset of regulators and the regulated community. There must be development and maintenance of a constructive dialogue between regulators and the regulated with the aim of securing professional buy-in which builds a relationship of mutual trust and setting the foundations for a successful OFR regime. It follows therefore that allowing greater flexibility in the development of regulatory structures/plans will enable ARs to develop a regulatory approach that is consistent and proportionate and tailored to its respective regulated community. We are firmly of the view that such an approach will lead to significantly higher standards of professional conduct and competence than the prescriptive and confrontational regime that be can superficially attractive. Furthermore, collaboration between the AR and its regulatory arm, leads to better regulation and higher compliance with standards as it is more productive for both sides to work together.

Question 4 - We would welcome views on whether self-assessment is an appropriate approach or whether the LSB should deliver its oversight by conducting its own reviews?

32. As the LSB has presented itself as being a non-prescriptive regulator which allows ARs the freedom to design their own approaches to regulation, self-assessment is more appropriate than the LSB conducting its own reviews. Self-assessments would be more in-line with the LSB's OFR approach whereby it will implement proportionate supervision and intervene only when there is a risk that regulatory objectives will not be met.

33. Both ILEX and IPS welcome the development of an appropriate self-assessment tool for the purposes of facilitating and reviewing an AR's regulatory infrastructure vis-à-vis the proposed key indicators at Annex A

of the discussion paper. By asking a series of questions, the self-assessment tool can act as a prompt to assist ARs to think about some of the key areas in which they might want to collect and analyse information as part of a monitoring process to ensure adherence to the regulatory objectives. An example of the suitability of self-assessment that both ILEX and IPS found useful was the Regulatory Independence Certificate initial assessment summary. All the applicable ARs are required to self-assess their compliance with the Internal Governance Rules (IGR) annually. We feel the development of the IGR self-assessment tool to facilitate AR compliance was not only helpful but proportionate.

34. That said, ILEX and IPS have noted that the proposed self-assessment exercise is the initial stage of implementation. It is further proposed that the LSB will engage in supervisory discussions with ARs; agree action plans for the AR to develop their regulatory model and performance; and undertake '*thematic reviews*' across the ARs. As a whole the regime appears intrusive and burdensome. The LSB should consider the burden they are placing on ARs. ARs work to a business plan and will now be asked to undertake additional work that they may not have planned. As a final point, the LSB does not indicate exactly what it will be reviewing and how often when conducting thematic reviews, which adds to the burden on ARs who will have to accommodate additional work at short notice.

Question 5 – What are your views on the benefits, costs and risk to ARs and their regulated communities in our proposals?

35. ILEX and IPS are committed to upholding and acting in a way that is consistent with the regulatory objectives in all that they do. Some of the proposals which the discussion paper intends to impose upon ARs may be seen to be disproportionate. In addition such proposals may place a heavy burden on the smaller ARs and indeed, the smaller firms/ABS.

36. The LSB has advocated OFR on the argument that the new regulatory approach will *'meet the tests that the 2007 Act sets for the LSB and ARs'* and that the current regime *'could not be described as promoting the regulatory objectives or upholding the better regulation principles'*. Firstly, the LSB has not yet specified why the new regulatory approach *'meets the tests'*; and secondly the *2007 Act* requires that ARs only *'promote'* the regulatory objectives, which under *section 28 of the 2007 Act*, means that ARs must *'so far as is reasonably practicable, act in a way which is compatible with the regulatory objectives and which the approved regulator considers most appropriate for the purpose of meeting the objectives.'* The Act appears to provide ARs with the freedom to decide how they will promote the regulatory objectives. The LSB does not appear to provide ARs with the same freedom.
37. There is no doubt that the approach the LSB has proposed is laudable. It will enable ARs to engage in effective risk assessment and as a result be able to target supervision on serious risks that undermine the regulatory objectives. However, with reference to paragraph 26 of the discussion paper, it does not appear that ARs have the freedom to choose how they will meet these relevant outcomes and principles of good regulation. During the passage of the Legal Services Bill, both Houses were reassured that the LSB would be an over-arching regulator and not in the business of micro-management. Some of the proposals seem to be bordering on micro-management.
38. ILEX and IPS agree that, if ARs develop an OFR approach, the reduction in prescriptive rules will mean there is less need for change to rules as circumstances change. Due to the nature of OFR regimes, detailed rules are replaced with high level outcomes and regulatees use guidance as a replacement for the detail that is lost when rules are converted into outcomes. Guidance is used in OFR regimes to supplement principles/outcomes and can appear in the form of industry codes; formal guidance from the regulator; informal guidance from the regulator including speeches and "Dear CEO" letters; public enforcement actions; decisions of

the Legal Ombudsman (LeO) and the ongoing dialogue between the regulator and the regulated community. ARs need to ensure that guidance is consistent and accessible. It is not enough to solely produce outcomes without ARs being able to monitor the guidance that the regulated community receive. A proliferation of guidance can lead to inconsistencies emerging in a less controlled environment.

Question 6 - We would particularly welcome feedback on the criteria at Annex A including suggestions on others that might be appropriate.

39. We have no objections to the criteria for regulatory standards at Annex A as long as there remains an element of flexibility and proportionality.

40. We accept that risk assessments are required in an OFR regime. ILEX and IPS will build on present experience of data collection. ILEX already has in place a robust system of risk assessment for education and training providers. ILEX and IPS are looking to expand their risk assessment system which may involve learning from other industries that already have in place sophisticated risk assessment tools. ILEX and IPS will work to ensure that their IT systems can facilitate and monitor extra data capacity,

41. ILEX as an AR has demonstrably proven its capacity and capability of regulating individuals in a robust and responsible manner. We have a regulatory framework in place that has the flexibility, together with a solid financial base, to make a successful transition from individual regulation to entity regulation having regard to the key indicators proposed in the discussion paper.

IPS/ILEX 29.07.11