

# The proportionality of legal services regulation

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A report for the Legal Services Board

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Economics, Policy and Regulation

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## **Disclaimer**

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## Table of Contents

Executive Summary.....	3
1 Introduction .....	5
1.1 Background to the study.....	5
1.2 Methodology.....	5
1.3 Rules, supervision and enforcement .....	6
1.4 The purpose of legal services regulation .....	6
2 Regulation under consideration .....	9
2.1 Education and training.....	9
2.2 Authorisation .....	14
2.3 Separate business rule.....	18
2.4 Consumer information disclosure.....	22
2.5 Regulatory information returns .....	25
2.6 Supervision.....	29
2.7 Insurance requirements.....	32
2.8 Separate client accounts.....	36
2.9 Compensation funds .....	39
2.10 Enforcement mechanisms .....	42
3 Assessment criteria for prioritisation of future investigation.....	45
3.1 Disproportionality .....	45
3.2 Screening criteria .....	47
3.3 Spread of options.....	51
3.4 Proposed prioritisation for future investigation.....	51

## Executive Summary

The Legal Services Board (LSB) is committed to ensuring that the legal services market is effective and competitive and that the approved regulators (ARs) meet the Government's principles of good regulation. This research considers the proportionality of regulation and seeks to help the LSB to focus its resources by setting out the priorities for further investigation.

In all, ten different issues are considered: education and training; authorisation; separate business rule; consumer information disclosure; regulatory information returns; supervision; professional indemnity insurance requirements; separate client accounts; compensation funds; and enforcement. For each issue, the purpose and benefits of regulation are set out along with factors which impact proportionality and the additional evidence needed to be able to draw conclusions on proportionality.

### *Proportional regulation*

While critics of regulation may perceive it as costly and unnecessary, regulation is usually aimed at improving the market. Through mitigating or improving underlying problems (market failures), regulators can bring benefits to consumers.

The LSB has previously commissioned work on the economic rationale for legal services regulation as well as work developing a market segmentation framework. Combined, these issues should affect regulatory design. In general, however, little differentiation in regulation between segments has been identified, hence this needs to be considered carefully in all future proportionality work.

As well as ensuring that the theoretical approach to regulation is appropriate, it is also important to take into account how regulation operates in practice. While the theory behind many regulatory approaches may be targeted to the underlying issues, the way that these rules are actually implemented may itself lead to disproportionality arising.

When conducting research and analysis to determine whether regulation is in fact proportionate, it is essential to ensure that the LSB and ARs consider a "first principles" approach to identifying the underlying problems and the best remedies for them. Once this has been identified, however, it is also vital to establish whether the benefits of changing from the current regulatory approach outweigh the costs of doing so. That is, it is important to acknowledge that there is already a set of existing regulation which will generally represent the relevant comparison against which to judge new regulatory action.

### *Assessment criteria for prioritisation of future investigation*

All of the regulation considered has a justifiable purpose and therefore no issue appears demonstrably disproportionate. However, all ten areas have evidence gaps which would need to be filled in order to be confident about whether or not regulation is, in fact, proportionate.

The prioritisation for future investigation has been based on a trade-off between number of criteria including: controversial issues where objective evidence should bring clarity; whether regulation brings compliance costs or wider market impacts; whether regulation is one-off or on-going and whether it applies to the whole market or a sub-set; inconsistencies across legal services; availability of existing evidence; the appropriate timing of evidence gathering; the feasibility of research; and

the benefits of including a spread of options including different types of regulation, different justifications for regulation, different segments of the market and different impacts of regulation.

Figure 1 below provides a graphical representation of the order of priorities of the different issues.

**Figure 1 Summary of priorities**

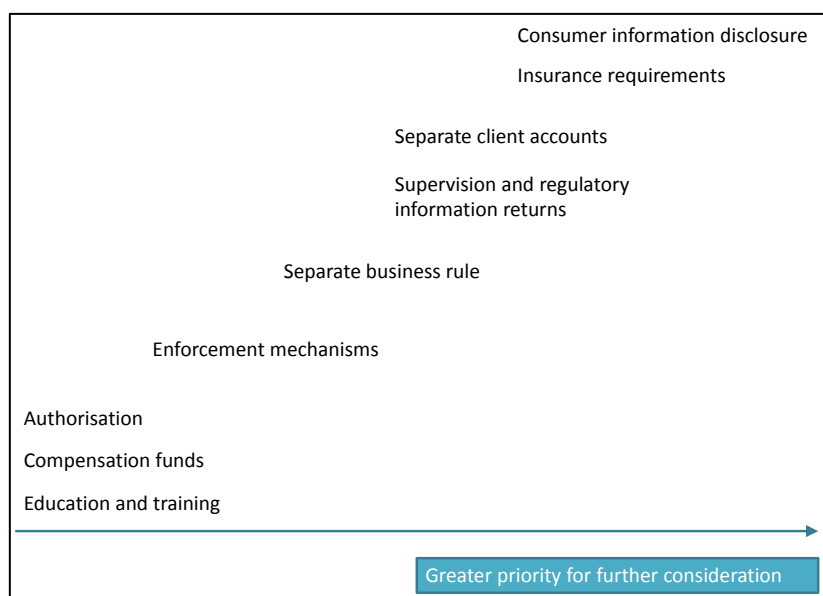


Figure 1 does not imply that the areas of regulation which are to the left of the picture are necessarily proportionate or indeed that they require no further investigation, but rather, that those to the right are the ones likely to be most fruitful for evidence gathering and analysis at this time.

#### *Next steps*

The most appropriate next step is for the LSB to discuss with the ARs whether, and to what extent, they already have evidence which addresses the specific issues highlighted in the report. Some of this may be readily available, while other issues may require interrogation of existing data in a new way and examination of that data in the light of concerns regarding proportionality.

In considering each of the ten issues, the report sets out some of the ideal evidence that would be needed in order to be able to assess whether the particular form of regulation is, in fact, proportionate to the underlying problems. Typically this includes a combination of data that can be gathered along with areas where a more qualitative understanding of the issues may be required.

In some of these cases the concerns regarding disproportionality are well-understood and ARs may already be taking steps to consider these. In other areas, evidence gathering will require primary research to be conducted beyond that which is already available from ARs and other sources. The priority as to where to focus such primary research should result from the priorities set out in Figure 1 adjusted in the light of any additional evidence gathered from ARs.

Given the breadth of issues it would also be appropriate for the LSB to work with the ARs to identify which areas of further investigation would best be led by individual ARs and which areas should be taken forward by the LSB.

## 1 Introduction

The Legal Services Board (LSB) is committed to ensuring that the legal services market is effective and competitive. In this report the focus of attention is on regulation itself with the LSB's ultimate aim to ensure that the proportionality of regulation is appropriately assessed.

This report is aimed at assisting the LSB in prioritising areas of regulation for further detailed work. It does not attempt to draw strong conclusions on whether particular regulations are, or are not, proportional but rather aims to help the LSB to focus its resources on those areas which are likely to be most fruitful for further investigation.

### 1.1 Background to the study

The Government has set out a number of principles of good regulation as follows:<sup>1</sup>

- Proportionate: Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised;
- Accountable: Regulators must be able to justify decisions, and be subject to public scrutiny;
- Consistent: Government rules and standards must be joined up and implemented fairly;
- Transparent: Regulators should be open, and keep regulations simple and user-friendly; and
- Targeted: Regulation should be focused on the problem, and minimise side effects.

The LSB is committed to ensuring that all regulation in the legal services market subscribes to these principles and this research is aimed at assisting the LSB with this through focussing on whether regulation is proportionate. Given the centrality of the law and the legal sector more widely, ensuring that regulation is proportionate and targeted not only ensures the legal services market functions well but also brings benefits to the rest of the economy.

### 1.2 Methodology

The aim of this report is to narrow down from a long list of areas of regulation the priorities for consideration in follow on investigation. The areas for consideration were developed by the LSB through reflecting on the lifecycle of a legal services firm and the different types of regulation faced at different stages. In all, ten different issues are considered: education and training; authorisation; separate business rule; consumer information disclosure; regulatory information returns; supervision; professional indemnity insurance (PII) requirements; separate client accounts; compensation funds; and enforcement.

In considering each issue, the purpose and benefits of regulation are set out along with various issues which impact conclusions on its proportionality. The intention is not to be exhaustive but rather to focus on the main issues each area of regulation addresses in order to assist in narrowing down the LSB's future investigation. Each section also sets out the evidence that would need to be gathered in subsequent evidence gathering and analysis in order to be able to assess proportionality.

Along with desk-based research, a small number of interviews were conducted with regulators and representative organisations. This work only considers firms and individuals regulated by the Solicitors Regulation Authority (SRA) and the Bar Standards Board (BSB) as these organisations regulate the largest numbers of providers of legal services. The focus on the SRA and BSB is not to

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<sup>1</sup> These "Principles of Good Regulation" were published by the Better Regulation Task Force in 2003.

suggest that the regulations set by these regulators are disproportional while those by other approved regulators (ARs) are proportional, but simply acts as a method of prioritisation. It is to be expected that the subsequent work which examines the actual proportionality of regulation would include the regulations and approach of the other ARs.

### 1.3 Rules, supervision and enforcement

Regulation can be thought of as consisting of a combination of rules, supervision and enforcement. The rules themselves set out those issues that individuals and firms need to adhere to with supervision and enforcement aimed at achieving compliance with the rules and punishment where this does not occur (with the threat of punishment itself aiding compliance). These three areas can act as both substitutes and complements for each other. For example:

- Supervision could act as a substitute for enforcement with issues being identified and resolved in the supervisory process and therefore reducing the number of problems for which enforcement cases are required; and/or
- Supervision could be effective in revealing problems which already exist and, with some of these cases requiring enforcement, increased detection through the supervisory process could lead to an increase in enforcement cases.

Alternatively, problems which arise in areas of redress and enforcement may reflect underlying issues in other parts of regulation. For example, if barriers to authorisation are set too low this may allow low quality firms to enter the market which are negligent (increasing PII claims), financially unviable (necessitating separate client accounts) and dishonest (increasing costs against the Compensation Fund).

One significant disadvantage in examining different types of regulation in turn, as is the case in this report, is that overlapping regulation (either between different rules, or between rules, supervision and enforcement) is not necessarily revealed. For example, in some cases it may be more proportional to allow a rare problem to arise and then fix it through enforcement and redress than to impose supervisory costs on the whole market in order to prevent it from arising. The follow-on work to assess proportionality would need to take into account the extent to which regulation overlaps when considering whether specific components are proportional.

### 1.4 The purpose of legal services regulation

While critics of regulation may perceive it as costly and unnecessary, regulation is usually aimed at improving the market. Through mitigating or improving underlying market failures such as the inability for consumers to understand all aspects of the legal services that they receive, the difficulty of judging the quality of advice or firms and the negative consequences that some poor quality providers can have on the whole market, regulators can bring benefits to consumers. Such benefits can include improving the quality of supply, increasing the competitive pressure from consumers, maintaining market participation and enabling redress when things go wrong. In addition, regulators in legal services also have an objective to support the principle of law.

The LSB previously commissioned work on the economic rationale for legal services regulation by the Regulatory Policy Institute.<sup>2</sup> The purpose of the different aspects of the regulatory structure considered in this report builds on that research as well as drawing on their conclusions that models of self-regulation may have tendencies to impose rules in the interests of those they regulate rather than the consumers of those services.

In addition, the LSB commissioned work from Oxera on a market segmentation framework for the legal services sector.<sup>3</sup> In part this aims to capture the fact that the extent of underlying market problems may differ in different parts of the legal services sector reflecting different clients, different types of legal issue, different levels of complexity of work etc.

### *Segmentation*

Combined, these issues should affect the proportionality of regulation in different areas. For example, the Regulatory Policy Institute point out that where quality is difficult to assess (perhaps because legal services need to be experienced in order to judge quality or because of asymmetric information more generally) reputation can be used rather than regulation to ensure that firms deliver quality services to clients. Yet, the strength of the role of reputation may vary across the different market segments set out by Oxera particularly according to different types of customer (natural person, legal person, Government). In general, however, relatively little differentiation in regulation between segments has been identified.

Indeed, the issue of segmentation is one that will be important to consider carefully in future proportionality work. While one type of regulation (e.g. supervision, consumer information disclosure) may generally be an appropriate regulatory response to a particular problem, the extent of the underlying problem and the effectiveness and cost of the solution are likely to vary in different segments. An important component of assessing proportionality is therefore to consider which characteristics, seen in which segments, are relevant to the issue at hand. In some cases, the cost of the regulatory response and risk of unintended consequences around regulatory boundaries will make a differentiated approach disproportionate, but consideration of these issues will ordinarily be required in order to draw conclusions on proportionality.

### *Practicalities of regulation*

As well as ensuring that the theoretical approach to regulation is appropriate and proportionate, it is also important to take into account how regulation operates in practice. While the theory behind many regulatory approaches may be targeted to the underlying issues, the way that these rules are actually implemented may itself lead to disproportionality arising. This could arise through a myriad of mechanisms such as undue complexity, requirements which are unnecessarily specific, engagement with participants that is more costly than it needs to be, and processes which take longer than is desirable. Such issues are highlighted where they have been identified, but these issues present a more general concern that ARs should have regard to when designing regulation.

### *Changes to regulation*

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<sup>2</sup> Regulatory Policy Institute, Understanding the economic rationale for legal services regulation, Decker and Yarrow, October 2010.

<sup>3</sup> Oxera, A framework to monitor the legal services sector, September 2011.



When conducting research and analysis to determine whether regulation is in fact proportionate, it is essential to ensure that the LSB and ARs consider a “first principles” approach to identifying the underlying problems within markets and the best manner through which these problems can be remedied. This approach is most likely to ensure that legal services regulators meet the Governments principles of good regulation.

However, many forms of regulation are already in place in legal services. Hence when considering whether or not to *change* regulation which has been identified as disproportionate, it is also important to establish whether the benefits of change actually outweigh the costs of change. Therefore the set of existing regulation will generally represent the relevant comparison against which to judge new regulatory action. Follow-on work to assess these issues would therefore be expected to examine this in considering whether changes to regulation are in fact the appropriate course of action.

## 2 Regulation under consideration

This chapter of the report considers the various different examples of regulation in turn. Each section provides a brief overview of the regulation itself along with explanation regarding the potential purposes of each type of regulation. It highlights the factors which impact proportionality and sets out the additional evidence needed to be able to draw conclusions on proportionality. Chapter 3 then considers the assessment criteria to be applied in order to determine which areas should be prioritised in further investigation.

### 2.1 Education and training

Before individuals can even be authorised to act as lawyers, they are required to possess certain qualifications and to have undergone training. As with many other professions, training is aimed at ensuring that lawyers are able to deliver high quality advice to their clients, which is particularly important where consumers are unable to assess quality. Education and training also helps the aim of supporting the rule of law.

However, one of the prime examples identified by the Regulatory Policy Institute of the danger of self-regulation (seen in legal services until very recently) was Guilds imposing educational and skill requirements to establish quality standards but which have the effect of limiting competition by raising barriers to entry, hence this issue may well give rise to regulation which is disproportional.

It is important context for this section to note that the BSB, ILEX Professional Standards and the SRA have commissioned a Legal Education and Training Review (LETR) which is due to report in June 2013.

#### *Structure of education and training regulations*

The BSB and the SRA have similar approaches to education and training with three different stages:<sup>4</sup>

- Academic – both the BSB and the SRA require that individuals have either a qualifying law degree or another degree supplemented by the Common Professional Examination (CPE) or Graduate Diploma in Law (GDL);
- Vocational – individuals must complete the Bar Professional Training Course (BPTC) or the Legal Practice Course (LPC) as appropriate. Student barristers are also required to join an Inn of Court; and
- Training:
  - Pupillage - Individuals must complete a 12 month pupillage during the second six months of which (the “Practising Six Months”) they can exercise rights of audience with permission of their supervisor or head of chambers. Individuals must attend an Advocacy Training Course (before practising) and Practice Management Course; or
  - Training contract - Individuals must complete a 2 year training contract during which they must complete the Professional Skills Course (PSC). Training must include 3 different areas of law, as well as both contentious and non-contentious work.

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<sup>4</sup> BSB, Qualifying as a Barrister available at [www.barstandardsboard.org.uk/qualifying-as-a-barrister/](http://www.barstandardsboard.org.uk/qualifying-as-a-barrister/) and SRA Training Regulations 2011 Part 1 – Qualification Regulations.

Both the BSB and SRA also have time limits relating to the completion and validity of the different stages (the SRA has recently agreed to remove some of these).<sup>5</sup> They also impose suitability tests such as not having criminal convictions. There are also requirements related to Continuing Professional Development (CPD) which are considered further below.

#### *Role of the Inns of Court*

The Inns of Court are societies providing collegiate, educational and support activities for barristers and students. Admission to an Inn must occur before registration for the BPTC. Advocacy training is delivered through the Inns and the Inns have the power to “call” a student to the Bar which happens after successful completion of the BPTC, although individuals need to complete their pupillage in order to exercise rights of audience. The significant difference in the number of students on the BPTC and the number of pupillages (see below) results in large numbers of individuals being called to the bar who do not subsequently practise. It is not obvious that this is efficient although it is understood that this may aid international students who practise elsewhere.

#### *Education and training as a barrier to entry*

Whether education and training forms a disproportionate barrier to entry depends on a number of issues, not least of which is the availability of places for each stage of the requirements. Centralised systems are in place for applications for the GDL, LPC and for pupillage vacancies which reduce search costs for individuals.<sup>6</sup> Table 1 below sets out details on the number of places available for various qualifications.

**Table 1: Number of places available**

	<b>Barristers</b>	<b>Solicitors</b>
<b>Academic – Law degree</b>	20,000	
<b>Academic – GDL</b>	5,440	
<b>Vocational – BPTC/LPC</b>	1,793	11,126
<b>Vocational pass rate</b>	84%	N/A
<b>Vocational places/total practising</b>	12%	9%
<b>Training – Pupillage / Training contract</b>	444	5,441
<b>Training pass rate</b>	N/A	N/A
<b>Training places/total practising</b>	3%	4%

Sources: Law degree places (2009) and number of training contracts from The Law Society, Trends in the solicitors profession, Annual statistical report 2010 or 2011 available from [www.lawsociety.org.uk/representation/research-trends/annual-statistical-reports/](http://www.lawsociety.org.uk/representation/research-trends/annual-statistical-reports/), List of GDL institutions 22 January 2013 and List of LPC institutions 28 February 2013 available from [www.lawcabs.ac.uk/](http://www.lawcabs.ac.uk/) BSB figures from [www.barstandardsboard.org.uk/media-centre/research-and-statistics/statistics/](http://www.barstandardsboard.org.uk/media-centre/research-and-statistics/statistics/) and relate to the following years: BPTC (2009/10), total barristers (2009, 2010), BPTC pass rate is the average of successful/enrolments for 2003/04-2009/10 pupillage (2010/11); Total solicitors with practising certificate January 2013 available from [www.sra.org.uk/sra/how-we-work/reports/data/population\\_solicitors.page](http://www.sra.org.uk/sra/how-we-work/reports/data/population_solicitors.page).

It is very clear from Table 1 that the training stage imposes the greatest constraint with a very dramatic reduction in available places compared to the academic or vocational stages. Indeed, the BSB, Bar Council, Inns of Court and BPTC providers have published a “health warning” to highlight

<sup>5</sup> SRA press release, Red Tape initiative amendments are just the start, 26 February 2013.

<sup>6</sup> Theoretically it is also possible that a single portal provides the opportunity for collusion or to enforce collusion between firms/chambers as firms can monitor the actions of their competitors.

this to prospective BPTC applicants.<sup>7</sup> Given the constraint imposed at the pupillage/training contract stage, any future consideration on barriers to entry from education should primarily focus here.

#### *Provision of training stage*

There are no restrictions on the total number of trainee contracts that can be offered and firms will determine this according to business needs. In order to offer training contracts, firms need to be authorised training establishments, must pay for trainees to do the PSC the first time, and “training principals” must be partner equivalents with at least four years’ experience and no more than two trainees each.<sup>8</sup> It is unclear why firms need to be specifically authorised as training establishments rather than authorisation conveying this ability since advising clients could be considered a more risky activity than training new lawyers.<sup>9</sup>

Part-time study routes are available in which individuals study for the LPC at the same time as working. Such an approach (similar to accountancy) places less upfront cost on individuals and could therefore affect the diversity of the profession. However, this may place greater costs on firms (as trainees would be less qualified and some would fail the LPC) which would reduce the appeal of offering training contracts (which is where the constraint currently lies).

There are no restrictions on the total number of pupillages that can be offered, although the fact that independent barristers are self-employed may alter the incentives to take on pupils in comparison to solicitors that are employed by firms. The number of pupillages expanded to 562 in 2007/08 but subsequently reduced in response to the economic climate. Responsibility for advocacy in the second six months lies with the pupil supervisor (who must have at least 6 years’ experience). Since pupils have not completed their pupillage, there is a risk that the advocacy conducted by pupils does not meet the necessary quality standards.

Finally, being qualified does not guarantee a job - neither solicitors nor barristers are able to operate as sole practitioners without 3 years’ experience. For barristers this highlights the tension of being self-employed yet relying on others to provide guidance in the early years after qualification.

#### *Assessment of completion of education and training*

Both the academic and vocational stages of training have objective assessments, primarily through exams. However, the assessment of the pupillage/trainee contract is much less clear. The BSB notes that it is rare for individuals to fail pupillage but those failures that do occur typically arise on training courses run by the Inns of Court (problems with advocacy or skeleton arguments are the most common issues).<sup>10</sup> Hence failures arise in respect of the “objectively assessed” stage which raises the concern that failures do not arise elsewhere because there is no objective assessment. Indeed there appears to be no disadvantage to the pupil supervisor of allowing their pupil to qualify since supervisors are under no obligation to offer “tenancy” in their Chambers (which would be strong evidence of competence although failure to receive tenancy does not indicate low quality

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<sup>7</sup> BSB, Health Warning for prospective Bar Professional Training Course Students available at: [www.barstandardsboard.org.uk/qualifying-as-a-barrister/bar-professional-training-course/](http://www.barstandardsboard.org.uk/qualifying-as-a-barrister/bar-professional-training-course/)

<sup>8</sup> It is also possible to offer training contracts through a training consortium between multiple firms.

<sup>9</sup> Note that the riskiness of providing training interacts with the assessment of completion of training.

<sup>10</sup> BSB, Pupillage Frequently Asked Questions available from: [www.barstandardsboard.org.uk/qualifying-as-a-barrister/pupillage/pupillage-frequently-asked-questions/](http://www.barstandardsboard.org.uk/qualifying-as-a-barrister/pupillage/pupillage-frequently-asked-questions/)

pupils as Chambers may not be able to take all pupils due to changing economic circumstances). Identical concerns arise in respect of trainee solicitors.

#### *Non-standard routes to qualification*

As well as the standard routes to qualification, there are some exceptions. For example, those who are Chartered Legal Executives or have been Justices' Clerk Assistants for five years do not need to undertake a training contract. It is unclear whether there is evidence that those qualifying through these routes impose no greater risks on consumers.

Similarly, lawyers who qualify in other jurisdictions do not have to complete the various stages but can take the Qualified Lawyers Transfer Scheme assessment (QLTS). Work examining PII for the SRA in 2010 identified that insurers were concerned that there was a disproportionate number of claims from foreign trained lawyers and, while the QLTS is a revision to previous arrangements, it is unclear whether PII providers retain the same concerns.<sup>11</sup>

#### *Price regulation*

The BSB and SRA have also regulated salaries during the pupillage / training stage. The BSB sets this at £12,000 per annum while the SRA sets it at £16,650 although will remove this from 1<sup>st</sup> August 2014.<sup>12</sup> While firms and Chambers will compete with each other through setting far higher salaries in order to attract the best candidates, some nonetheless apply the minimum salaries. It is extremely unusual for regulators to set salaries and price regulation is typically one of the most interventionist forms of regulation for which there must be very strong evidence. Arguments that minimum salaries prevent exploitation of staff and contribute to the diversity of the profession are weakened in a context of a national minimum wage although it may be necessary to consider this in the light of self-employment for barristers.

#### *Administrative requirements*

There are a large number of issues linked to education and training where regulators require information or certain steps to be taken which may not be proportional:

- Entry requirements are set for the GDL rather than allowing GDL providers to set these while maintaining outcomes;
- Students have to enrol with the SRA before commencing the LPC;
- The SRA requires individuals to obtain a "certificate of completion" of the academic stage;
- Trainees/pupils and training establishments are required to inform the BSB and SRA that they are starting the training stage and the SRA to cancel them; and
- Information on trainee salaries needs to be provided to the SRA.

Many of these issues appear to require regulators to interact with large numbers of individuals before qualification, many of whom will not go on to practise.

#### *Link between educational requirements and subsequent practice*

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<sup>11</sup> CRA International, Review of SRA client financial protection arrangements, September 2010. Note that Kyla Malcolm was the lead author of the CRA report.

<sup>12</sup> The London minimum salary is £18,590. SRA, Trainee Minimum salary levels for 2011-2014, 1 June 2012.

Passing the various educational and training requirements and successfully obtaining a job means that individuals are then qualified to practise as barristers and solicitors. Other than in a small number of areas where additional qualifications are required, individuals can advise on a wide range of legal issues even if these are not issues on which they have received specific training. Conversely, many lawyers receive training in areas which they do not then subsequently use. It is possible that the wider training helps to support the aim of upholding the principle of law generally, but it may simply impose costs by having training requirements that are wider than those needed. Some large firms have designed their own versions of the LPC in connection with training providers in order to overcome this issue although certain requirements remain compulsory.

### *Continuing Professional Development*

As well as obtaining initial qualifications, individuals are required to undertake on-going training. The SRA requires that solicitors take 16 hours of CPD each year of which at least 25% must be through participation in specifically approved structured training but the rest of which can be self-certified leaving this open to potential abuse. Firms can have a waiver from routine monitoring requirements of CPD if they have other quality marks such as Lexcel, Investors in People, ISO9000, authorised in-house CPD providers, and Legal Aid franchises. There are also some specific training requirements including:

- 5 hours of CPD relating to advocacy in higher courts in each of first 5 CPD years following grant of higher rights;
- During the first three CPD years, individuals must attend SRA Management Course Stage 1 covering at least three of managing: finance, firm, client relationships, information, and people (although exemptions are possible); and
- If qualified through QLTS, individuals must attend Finance and Business skills but do not need to attempt the exam or pass it. They must also complete the Client Care and Professional Standards modules of the PSC during their first CPD year.

Barristers must also undertake a Forensic Accountancy Course during pupillage or the first three years of practice during which they must also complete 45 hours of CPD. After this there is an annual requirement of 12 hours of CPD.<sup>13</sup>

**Table 2: Education and training**

	<b>Education and training</b>
<b>Purpose of regulation</b>	Ensure quality of lawyers and therefore reduce detriment from poor advice; uphold the constitutional principle of law.
<b>Extent and variation in risk by segment</b>	Quality of advice is one of most significant risks but likely to be difficult to link poor advice specifically to education. Risk of poor advice likely to vary by segment.
<b>Variation between regulators</b>	Similar structure for BSB and SRA with academic, vocational, training stages. BSB requires 12 month pupillage where SRA requires 24 month trainee contract with 3 different areas of work.
<b>Targeted and effective regulation</b>	Unclear why individuals need to be trained in multiple areas of work if they will only work in one, but reflects qualification as a solicitor/barrister rather

<sup>13</sup> BSB Code of Conduct, Annexe C – The CPD Regulations.

	than being more specific. Arguably less of a concern with barristers as advocacy is a more focused segment already. No objective assessment of completion of training/pupillage or CPD.
<b>Market impacts beyond those under purpose</b>	Potential barrier to entry at pupillage/training stage. Price control on pupillage salaries (trainee salary regulation to be removed in 2014)
<b>Costs</b>	Non-trivial costs of gaining qualifications paid by individuals (some firms may assist) may have implications for diversity of the profession as well as price of legal services. Firms pay for some training (PSC, CPD).

### *Evidence required to assess proportionality*

There is a range of ideal evidence which would be required in order to assess whether existing rules related to education and training are proportional:

- Consideration of whether training courses cover appropriate skills – survey of newly qualified to assess what proportion of vocational and training courses are used in reality;
- Proportion of firms that are training establishments – should be available from SRA;
- Reasons for not being training establishments and/or not taking on new pupils/trainees – survey of those who do not offer training stage;
- Proportion of pupils/trainees not offered tenancy/full-time positions with existing Chambers/firms – some evidence should be available from SRA which would provide an upper bound on the size of concern about lack of assessment;
- Assessment of impact of self-employed status in independent bar on offering pupillages, diversity of profession and interaction with price controls – comparison of number of pupillages by employed bar compared to independent bar should be available from BSB, other issues require bespoke research;
- Evidence on PII claims against pupil supervisors due to poor advice by pupils in second six months, those qualifying through non-standard routes, newly qualified solicitors and barristers – should be available from insurers; and
- Evidence on costs of different stages of qualification – data on cost of qualifications should be available from colleges / other providers.

Many of these pieces of evidence (and more) may result from the LETR.

## 2.2 Authorisation

In order to conduct approved legal services, firms and individuals need to be authorised to do so. As part of the authorisation process, regulators set out a range of conditions which they must meet. These apply both on initial entry to the market (e.g. setting up a new firm) as well as on an on-going basis (e.g. renewal of practising certificates).

The purpose of the authorisation rules is to ensure that only those firms that are competent to offer (reserved) legal services are able to do so and therefore they aim to protect consumers from low quality advice or from business models that would impose undue risks on consumers. Authorisation processes clearly act as a barrier to entry, indeed they are partly designed to do so. It is possible, however, that the authorisation process is set too high (preventing entry by firms that could offer legal services without imposing undue consumer detriment) or too low (allowing entry by firms that

impose excessive consumer detriment). Authorisation requirements also enable ARs to know who is in their regulated community.

#### *Barrier to entry*

The table below sets out the number of firms and new firms in order to help assess whether there is evidence of authorisation causing undue barriers to entry. Barristers are often organised through Chambers which are offices from which more than one self-employed barristers work, sharing administrative teams and other office costs; Chambers are counted as firms in the table below.

**Table 3: Number of firms**

	<b>Barristers</b>	<b>Solicitors</b>
<b>Number of chambers/firms</b>	768	10,819
<b>-of which sole practitioners</b>	427	3,309
<b>Number of new firms</b>	At least 34	864
<b>New firm rate</b>	4%	8%

Sources: BSB statistics for 2011 from Bar Barometer Trends in the profile of the Bar, November 2012, new firms data calculated as a difference from 2010 to 2011 which therefore represents a lower bound; SRA statistics available from [www.sra.org.uk/sra/how-we-work/reports/statistics/regulated-community-statistics.page](http://www.sra.org.uk/sra/how-we-work/reports/statistics/regulated-community-statistics.page), Breakdown of solicitor firms for January 2013 and new firms for 2012.

The number of firms and the new firm rates do not immediately suggest that authorisation is preventing entry. In the case of solicitors, the number of new firms fell in 2012 as did total sole practitioners (down 11% since February 2011) but it remains to be seen whether this simply reflects usual fluctuations and economic conditions or changes in the authorisation process.

#### *Authorisation costs*

Authorisation and practising certificate fees apply on different bases:

- For barristers, they depend on the number of years since call, whether the individual is a QC, with the possibility of a low income discount and could range from £83 for a newly qualified barrister to £1,361 for a QC called before 1974. The BSB is consulting on preferences regarding allocating costs according to seniority, income and flat fees;<sup>14</sup> and
- For solicitors, there is a flat fee of £344 for each solicitor and a firm fee which is a declining proportion of turnover (0.86% declining to 0.08%).<sup>15</sup>

In neither case does the total amount appear prohibitive in terms of creating an unnecessary barrier to entry although the more efficient regulators are, the lower costs would be.

#### *Specific work areas*

In general, once firms are authorised they can conduct any type of work although there are a small number of cases in which additional requirements are made such as in respect of individuals exercising rights of audience where a specific qualification must be obtained and, while the quality assurance for advocates scheme is still under development, the SRA must be notified where individuals exercise this right in respect of criminal advocacy. Similarly, foreign law firms must be

<sup>14</sup> BSB, Schedule of Practising Certificate Fees 2013/14 Policy and Guidance (QC calculated as £1202 core fee, £117 pension levy, £42 LSB and Legal Ombudsman levy). BSB, Practising certificate fee consultation.

<sup>15</sup> SRA fee policy 2012/2013



registered to conduct immigration advice.<sup>16</sup> It is unclear whether granting authorisation across the board is proportionate to risks involved in some segments or whether a more targeted approach would be appropriate. More detailed consideration of this would be needed to assess risks in different segments.

#### *Administrative effectiveness*

There are a number of areas of the authorisation rules where there are questions about whether administrative complexities and costs are proportional:

- Regulation arises for both firms and individuals potentially leading to duplication;
- Solicitor sole practitioners who meet the qualifying requirements apply for authorisation rather than notify their intent to be a sole practitioner and only 2 applications were refused in 2012 (this interacts with the point above);<sup>17</sup>
- Practising certificates are renewed each year for both solicitors and barristers although online renewal should reduce the costs associated to this, it appears mainly an administrative exercise with, for example, barristers simply verifying contact details, practising status, completion of CPD, existence of insurance and paying the relevant fee;<sup>18</sup>
- The existence of both the SRA register and the “roll”, and whether the £20 fee to be on the roll covers its costs;<sup>19</sup>
- Authorisation applications forms from the SRA which stretch to nearly 100 pages in some cases and where simplification may be possible; and
- Authorisation requirements vary by different type of firm structure although it is not clear the extent to which this reflects different risks.

#### *Experience required*

There is some suggestion of areas where authorisation requirements are insufficient including solicitor sole practitioners who must be “qualified to supervise” which requires them to have practised for at least 36 months of the last 10 years (which can include time as a lawyer in another jurisdiction) and to have completed SRA training currently set as 12 hours of management skills. In 2010, PII providers stated that these firms were statistically more risky than others and suggested that individuals should have at least 5 years’ experience. It is also noteworthy that individuals need less experience to become a sole practitioner (3 years) than they do to train another lawyer (4 years) even though in the former case they will be advising clients.<sup>20</sup>

In the case of barristers of less than three years standing, they can only exercise rights of audience if part of a Chambers/office with a qualified person available to provide guidance to the barrister. The qualified person must have 6 years’ experience. Barristers are not able to act directly for the public

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<sup>16</sup> SRA Practice Framework Rules 2011, Rule 4.19

<sup>17</sup> SRA Regulatory Outcomes report, December 2012, section 3.1.

<sup>18</sup> BSB, Schedule of Practising Certificate Fees 2013/14 Policy and Guidance.

<sup>19</sup> Rule 15.1. It is also surprising that the £20 is waived after individuals have been on the roll for 50 years.

<sup>20</sup> Note that the riskiness of training interacts with the assessment of completion of training.

for 3 years.<sup>21</sup> It is unclear whether there are undue risks arising from this source and the difference between advising clients and training others is again noted.

#### *ABS authorisation*

In respect of the authorisation of Alternative Business Structures (ABSs), only the SRA and the Council for Licensed Conveyancers (CLC) are currently licensing authorities, although the latter's regulation has not been included within the scope of this report.

The SRA started receiving ABS applications on 3 January 2012. During 2012 it received 240 Stage 2 applications but only around 30% of these were deemed complete and 72 bodies had been licensed by the end of the year.<sup>22</sup> It is unclear whether the lack of completeness to application forms is because applicants are simply failing to provide necessary information or because SRA guidance regarding what should be provided is insufficient.

Concerns have been raised regarding the ABS authorisation process, both in respect of the length of the application form but also the time taken to authorise these firms which could be up to six months.<sup>23</sup> Since 2012 was the first year of authorising these bodies it is perhaps not surprising that some difficulties were encountered but the time and complexity of the authorisation process may be limiting entry from the very source from which new innovation is expected. The SRA has committed to making changes in this area and is in the process of rebalancing resources and priorities.<sup>24</sup>

The BSB intends to regulate entities and apply to licence ABSs although is still reviewing consultation results on a new handbook. Clearly it will be important that their approach is proportionate.<sup>25</sup>

#### *Summary*

**Table 4: Authorisation**

	<b>Authorisation</b>
<b>Purpose of regulation</b>	Prevent unqualified / incompetent providers of reserved activities. Reduce wider reputational damage.
<b>Extent and variation in risk by segment</b>	Risks to clients likely to vary across segments even among reserved activities yet authorisation tends to apply across the board.
<b>Variation between regulators</b>	Prevalence of self-employed barristers places greatest focus on individuals rather than Chambers whereas SRA has detailed firm-based authorisation.
<b>Targeted and effective regulation</b>	Some concerns about administrative requirements and approach especially with respect to ABSs although this relates to the first year of licensing.
<b>Market impacts beyond those under purpose</b>	New entry may be delayed or prevented by administrative complexity. Some evidence of entry by firms that may be unduly risky (QLTS, 3 year experience for sole practitioners).
<b>Costs</b>	Costs of completing complex application forms. Authorisation/practising certificate fees and administration costs by regulators.

<sup>21</sup> Barristers Code of Conduct, Rule 203 and 204.

<sup>22</sup> It is unclear whether entities submit multiple applications which may be distorting these proportions.

<sup>23</sup> This was one of the areas in which the LSB has expressed concern regarding the SRA's performance. Source: LSB press release, SRA's regulatory assessment: much done, much to do, 27 February 2013.

<sup>24</sup> LSB, Developing Regulatory Standards, An assessment of the Solicitors Regulation Authority, February 2013.

<sup>25</sup> BSB, Entity Regulation available from [www.barstandardsboard.org.uk/regulatory-requirements/changes-to-regulation/entity-regulation/](http://www.barstandardsboard.org.uk/regulatory-requirements/changes-to-regulation/entity-regulation/)

*Evidence required to assess proportionality*

There is a range of ideal evidence which would be required in order to assess whether the authorisation process is proportional:

- Consideration of new entry – Examination of trends over time regarding new firms to assess the impact of any changes in authorisation, examination of the number of firms that are rejected during the authorisation process and whether this changes over time – Data available from SRA, and discussions to be held with recent, potential and rejected entrants;
- Concerns about entry standards being too low – Information available from PII providers regarding where/whether high risks are seen for new firms / sole practitioners with limited experience; and
- Consideration of whether high entry barriers lead firms to conduct reserved activities outside of regulation – data on firms found to be operating outside the regulatory boundary.

### 2.3 Separate business rule

The SRA restricts the services that solicitors can offer through a separate business – referred to here as the separate business rule (SBR) – although there is no equivalent for barristers.<sup>26</sup> Firms must make sure clients are not misled about the extent of their regulatory protection, and in connection to a separate business the SRA:

- prohibits ““mainstream” legal services which members of the public would expect firms to offer as a lawyer regulated by the SRA or another approved regulator”; and
- permits “services a member of the public would not necessarily expect to be provided only by a lawyer regulated by the SRA or another approved regulator, but which are “solicitor-like” services”.

The intention of the SBR is to ensure clients are protected when they receive mainstream legal services from a SRA-regulated firm and to prevent clients from being confused about the level of regulatory protection that they receive.

*Protection of consumers*

Various legal services are “reserved” such that only those who are regulated can offer them in order to ensure that consumers are protected in areas where they might otherwise suffer detriment. If the boundary of reserved activities is appropriately drawn then consumers should not need regulatory protection in non-reserved, but mainstream, activities. In this case the aim of SBR to protect consumers seems unnecessary (whether it reduces confusion is considered below).<sup>27</sup> If, in fact, consumers *do* need regulatory protection in respect of other activities then reserving these activities would be a more targeted remedy to the issue rather than to tackle the need for protection through the far less direct measure of the SBR (assuming reservation itself is proportionate).

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<sup>26</sup> SRA code of conduct, Chapter 12: Separate businesses. The SRA also requires that firms only be connected with an appointed representative (AR) if the AR is an independent financial adviser (IFA). Since all ARs are regulated by the Financial Services Authority (FSA) and meet FSA rules, it is unclear why the SRA imposes this.

<sup>27</sup> The same argument would appear to apply for non-reserved activities through the same business as well as through separate businesses.

It may be the case that the maintenance of the SBR reflects the view that other (non-reserved) activities *do* require regulatory protection, as well as there being a possible inconsistency between reservation focused on activities and the SRA's regulatory remit focused on solicitors.<sup>28</sup> Logically, which activities should be reserved, should be the primary question.<sup>29</sup> Evidence on the extent to which detriment is currently arising through non-regulated firms would be expected to feed into this consideration.

#### *Consumer confusion*

The SBR prevents firms from deliberately seeking to split into two businesses: one of which is regulated and undertakes reserved activities; and one of which is not regulated and undertakes non-reserved activities. Where clients seek a combination of services from a law firm structured in this way (either at the same time or over a period of time) there is a risk that clients would mistakenly believe that they have regulatory protection for *all* activities when in fact they only receive it for the *reserved* activities. Such a risk would be exacerbated by the use of similar brands and staff.

The SRA commissioned research using 40 in-depth interviews with individual consumers. This identified that consumers were generally surprised and concerned to learn some legal services were not regulated and were unaware of how to tell the difference between a regulated and unregulated provider.<sup>30</sup> The Legal Services Consumer Panel (LSCP) used this evidence to support their view that firms should not be able to conduct some work through unregulated separate entities.<sup>31</sup>

This evidence shows that consumers may have inaccurate expectations about current regulatory standards, and therefore may support the SRA and LSCP's concerns about confusion. However, in the absence of the SBR, consumers would be confused about the level of protection in an area where policymakers have determined that consumers *do not* require protection. Hence this should only be of concern if the confusion prevents some consumers from taking other steps to protect themselves.

#### *Distortion of competition*

The SBR distorts competition over non-reserved activities as non-regulated businesses can compete for these but only if they are not connected to a regulated firm. The SBR may therefore prevent new entry or innovative business models being used in unreserved activities.<sup>32</sup> For example a claims management company (CMC) or insurer may wish to buy a law firm (perhaps to run simple cases) but still use alternative law firms (for more complex cases). The effect of this could be that the

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<sup>28</sup> This appears to be the suggestion behind comments by the SRA in Legal Futures, Exclusive: SRA rejects LSB call for review of separate business rule, 20 February 2013.

<sup>29</sup> Previous research has indicated that the current set of reserved activities has arisen through a combination of individual decisions rather than a comprehensive assessment of the market as a whole. Legal Services Institute, *The Regulation of Legal Services: Reserved Legal Activities: History and Rationale*, August 2010 and *The Regulation of Legal Services: What is the case for reservation*, Interim Discussion Paper, July 2011.

<sup>30</sup> SRA, *Consumer attitudes towards the purchase of legal services*, An overview of SRA research findings, February 2011.

<sup>31</sup> Legal Futures, *Consumer panel backs separate business rule with dig at the Co-op*, 19 January 2011.

<sup>32</sup> It is also possible that over time competition in reserved activities is affected if firms are prevented from exploiting synergies between separate businesses delivering reserved and non-reserved activities.

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CMC/insurer can no longer undertake preparatory work itself (even if it used to do this) but would need to conduct it within the law firm.<sup>33</sup>

### *Effectiveness and waivers*

During the authorisation process of ABSs, the SRA has provided waivers to the SBR on multiple occasions. If the SBR is commonly waived in the very circumstances in which firms have separate businesses, this calls into question the purpose of the rule. Furthermore, having a rule but then waiving it may lack transparency for firms that are considering setting up businesses but do not do so because they do not realise that a waiver could be granted. This process may also mean that distortions arise between ABSs and non-ABSs.

In addition, transparency in the SRA's approach may be lacking in that firms may not be able to determine in advance the difference between "mainstream" legal services and "solicitor-like" services. Indeed given that this test is described as being based on public expectations it is unclear whether there is evidence of whether public expectations do actually differ in this regard.

Conversely, rules combined with waivers provide a process through which the SRA can assess whether proposed business models will impose undue risk on clients (although conflicts of interest rules may be sufficient for this purpose). If, in practice, separate businesses are allowed where risks are small then this also limits the extent to which competition is distorted in reality.

### *Application to non-reserved services generally*

Although this section has focused on the SBR, this has also revealed that much of the discussion has applicability to non-reserved activities conducted within law firms (as distinct from being conducted in a separate business). Many of the SRA's rules apply across the whole of a solicitor's business and typically do not distinguish between reserved and non-reserved activities (this would also be the case for many of the rules of other ARs). In particular, in the same way as described above where concerns about consumer protection in a separate business are unnecessary if the boundary of reservation is appropriately drawn, an analogous argument applies to non-reserved activities within a law firm i.e. protection for non-reserved activities within the same law firm would be unnecessary.

However, the potential for consumer confusion regarding consumer protection would be expected to be greater if consumers face different levels of protection for different services received from the same firm. The extent to which such confusion would arise, or could be mitigated by different regulatory approaches would need to be tested and would be expected to vary across different market segments. Once again this serves to highlight the importance of conducting research and analysis to ensure that regulation is proportionate.

In addition, it is worth noted that the Ministry of Justice has launched its Legal Services Review which will examine the legal services framework.<sup>34</sup> It is unknown whether this review will consider the boundary of reservation, but, if it does, this will clearly have implications for research in this area.

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<sup>33</sup> This example draws on that suggested in Legal Futures, Will the separate business rule ruin CMCs' plans to become ABSs? 31 October 2011.

<sup>34</sup> Written Ministerial Statement, Ministry of Justice, Legal Services Review Call for Evidence, 5 June 2013.

*Summary***Table 5: Separate business rule**

	<b>Separate business rule</b>
<b>Purpose of regulation</b>	Protect consumers when receiving mainstream but non-reserved legal services. Prevent consumer confusion.
<b>Extent and variation in risk by segment</b>	If the regulatory boundary is appropriate then there should be limited risk attached to non-reserved legal services. Individual consumers at greater risk than corporates and evidence of confusion about the existence of non-regulated providers. Risk lowered where overall brand reputation could be damaged through misleading consumers.
<b>Variation between regulators</b>	SRA only.
<b>Targeted and effective regulation</b>	SBR may be compensating for inappropriate boundary of reserved activities Unclear effectiveness of waiver policy.
<b>Market impacts beyond those under purpose</b>	Potential for competition to be distorted in non-reserved activities, reduced entry and innovation. Consumers may have (sometimes misplaced) confidence in regulatory oversight thereby currently increasing participation in legal services. Removal of SBR could have substantial impacts in reducing regulatory oversight and reshaping the regulated community with associated consequences for the SRA itself.
<b>Costs</b>	Increased costs of authorisation process, regulatory costs may be applied across more activities than are necessary.

*Evidence required to assess proportionality*

There is a range of ideal evidence which would be required in order to assess whether the SBR is proportional:

- Examination of which business models have been prevented by SBR and the effectiveness of the use of waivers – this would require discussions with new entrants and potential entrants;
- Greater testing of consumer confusion and actions they would take if they discovered services were unregulated and testing of public expectations regarding “mainstream” v “solicitor-like” services – would require consumer testing;
- Consideration of alternative approaches to limit consumer confusion such as:
  - Disclosure of information requiring consumer testing on its effectiveness and cost (and noting that this could not be imposed systematically on non-regulated firms);
  - Restrictions placed on firms where business models brought undue risk;
- Consideration of the likelihood of firms setting up separate businesses for reserved and non-reserved activities – depends on overall regulatory costs for reserved activities, costs of running two businesses, and cost of SRA checking business models; and
- Examination of the potential consequences of substantial movements of non-reserved activities outside of regulation including reduction in regulatory oversight, potential reshaping of regulated community and associated implications for regulators and regulatory

fees – necessitates transparent debate on whether reserved activities are appropriately identified (*before* unintended consequences result); it also raises the question of why some of the other ARs have regulatory power if they do not deal with reserved activities. This issue would become all the more significant if the debate was widened to include non-reserved activities within the same business.

It is important to note that if the underlying question is one of whether the boundary of reservation is appropriate, then research into other issues, while useful in determining the impact of the SBR, would not, on its own, give confidence to regulators on the full effect of its removal. In particular, regulators would still be left with the question of whether detriment arises from those non-reserved activities which would no longer have regulatory oversight.

## 2.4 Consumer information disclosure

Lack of legal expertise and infrequent use of legal services puts many clients in a weak position when receiving legal services (i.e. they suffer from asymmetric information). Information disclosure is a common approach to reduce this asymmetry and may bring advantages including:

- Helping consumers to understand the service they will receive in order that consumers are better able to assess the value of those services;
- Revealing the expected cost of services and the basis of the cost which could both reveal incentive problems (e.g. potential for overselling or conflicts due to fee arrangements) and could also lead consumers to shop around for alternative suppliers; and
- Enabling consumers to obtain redress that they would otherwise fail to receive by informing them about redress mechanisms.

### *Disclosure to end clients*

Both the BSB and the SRA have certain requirements in place when dealing directly with end clients:

- The BSB requires that clients are informed about the work the barrister will perform, that they cannot be expected to perform the functions of a solicitor, that they are a sole practitioner, that professional duties may prevent the barrister from completing work, the fees and their basis of calculation, contact details, and complaints procedures;<sup>35</sup> and
- The SRA requires that clients are informed about whether services are regulated, complaints mechanisms, how their case will be handled, expected costs, and acts or omissions which could give rise to a claim against the lawyer by the client. One of the changes from Outcomes Focused Regulation has been to provide greater flexibility in this area and the SRA also notes that the information provided will vary by client and type of work, representing a good example of where different segments are taken into account.<sup>36</sup>

### *Effectiveness of disclosure*

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<sup>35</sup> BSB Code of Conduct, Annex F2 – Public Access Rules, paragraph 6. The Bar Council provides a model letter designed to fulfil these requirements which could both ensure that requirements are met and aid comparison between barristers if solicitors or their clients shop around on the basis of terms of business arrangements.

<sup>36</sup> SRA Handbook, Chapter 1, Outcomes 1.9-1.11.

With the exception of issues to do with complaints (considered below), there is limited concern among interviewees regarding disclosure. Providing terms of business agreements including setting out the services and expected costs is seen as something that could not be objected to. However, historically there has been little assessment of whether disclosure requirements are actually *effective* in legal services, with few examples of consumer testing. In order to assess whether disclosure is effective, there are a number of important steps including considering:

- Whether consumers actually receive the information they are supposed to receive;
- Whether consumers read and understand it; and
- Whether consumers act on it and, if so, how.

These issues would be expected to vary across different market segments reflecting issues such as client type, the extent to which legal services are a “distress” purchase, the expected cost of services and whether services are relatively standardised (facilitating comparison). For example, individual consumers could search on the basis of information online, then select the lawyer and only receive disclosure documents once they have completed their search process. Other consumers such as large corporates may not search on the basis of regulated information but rather on reputation. Furthermore, little evidence has been gathered on the cost implications of disclosure requirements including both the initial time spent developing them and any on-going costs of their provision.

#### *Information disclosure regarding the complaints process*

Both the BSB and the SRA require that at the start of their engagement, clients are informed in writing about: their right to complain and how complaints can be made; their right to complain to the Legal Ombudsman, the time frame for doing so, and contact details for the Legal Ombudsman.<sup>37</sup>

SRA research indicates that although consumers are not particularly aware of how to complain they nonetheless generally thought they would complain to the provider first.<sup>38</sup> It is therefore questionable whether providing information telling consumers they should complain to the provider first actually *informs* consumers, although they may become informed about the Legal Ombudsman. In addition, even where information is disclosed and understood at the start of the advice process lawyers, complaints are likely to arise during or at the end of the process by which time clients may have forgotten or thrown away the information they were given.

During interviews for this research, concerns were highlighted about the effectiveness of disclosure requirements in the context of work referred by solicitors to barristers. The BSB requires that where there is no letter of engagement, “a specific letter must be sent to [lay clients] notifying of the [complaints] information”.<sup>39</sup> The particular concerns arise in cases where interactions between barristers and the client are relatively limited, barristers may not have access to the contact details of the client and, in the absence of a general terms of business letter (as this is sent by the solicitor rather than the barrister), focusing on complaints sets an odd tone for the provision of services.

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<sup>37</sup> SRA Handbook, Chapter 1, Outcomes 1.9-1.11 and BSB Code of Conduct, Annex S. If it is not practicable at the time of engagement, barristers may notify clients about complaints “at the next appropriate opportunity”. The BSB also requires that Chambers’ websites and literature carry information about the complaints process.

<sup>38</sup> SRA, Consumer attitudes towards the purchase of legal services, An overview of SRA research findings, February 2011.

<sup>39</sup> BSB Code of Conduct, Annex S, paragraph 1.



Furthermore, there are worries that the perceived impracticality of the rules may mean that it is very difficult for barristers to comply with them. That is, it is not so much the question of whether consumers should be informed, but rather how they can be most effectively informed.

More generally, the role of information disclosure will differ when solicitors instruct barristers on behalf of clients. For example, in these cases information disclosure would not play a strong role in shopping around for barristers, and clients may also depend on solicitors to help them assess the value of the barrister's service. The extent to which this occurs is likely to vary across market segments. However, this raises the possibility that the most effective form of information disclosure could be when provided by solicitors rather than barristers. Yet, consideration of this may be hindered by the current regulatory structure i.e. the BSB cannot oblige solicitors to provide information on behalf of barristers and it is not part of the SRA's remit to ensure barristers' information requirements are fulfilled.

### Summary

**Table 6: Consumer information disclosure**

	<b>Consumer information disclosure</b>
<b>Purpose of regulation</b>	Reduce asymmetry of information through increasing understanding of services, costs and redress mechanisms.
<b>Extent and variation in risk by segment</b>	Guidance that there should be variation by client type (SRA) and differing rules depending on whether direct access (BSB).
<b>Variation between regulators</b>	Reasonably similar approach.
<b>Targeted and effective regulation</b>	Some concern that disclosure in relation to complaints procedures (and possibly other issues) may not be practical for barristers when work is referred by solicitors.
<b>Market impacts beyond those under purpose</b>	If unduly costly could prevent entry by small firms due to fixed cost of compliance.
<b>Costs</b>	Fixed costs of design set up, cost of providing information to consumers (noting that if requirements are not being followed then both costs and benefits will be reduced).

### *Evidence required to assess proportionality*

There is a range of ideal evidence which would be required in order to assess whether existing approaches to consumer information disclosure are proportional:

- Market testing of whether consumers actually receive, read and use information – although this could be done through market surveys, the use of “shadow shopping” where the actual behaviour of real clients is observed may be more effective in understanding which aspects of information they find useful. Evidence from other similar sectors may also be useful in identifying the likely magnitude of the effectiveness of disclosure;
- Examination of disclosure of complaints process – survey of recent clients (split by referred and direct access) to identify whether information is actually disclosed, read and used; consideration of whether clients already understand who to complain to and whether information provision prompts clients to seek redress; and

- Assessment of how consumers complain - evidence on who clients complain to in practice (i.e. whether clients first complain to the solicitor even if their complaint relates to a barrister) could be available from a survey of complainants or evidence from the Legal Ombudsman, solicitors and barristers who have faced complaints.

## 2.5 Regulatory information returns

It is common for regulators to gather information from those that they regulate, but gathering information per se has no effect. Instead, it needs to be used to shape other parts of the regulatory approach. Indeed, this issue links very closely to the supervision process. The key questions in terms of proportionality are therefore whether the content of information, the manner in which it is gathered, and the way in which it is used in practice, are all appropriate and aligned - at the most basic level, there is no point in collecting information which is not used. Information can be used by regulators in a number of ways including identifying:

- Compliance with rules – much of the historic information gathering has focused on this, such as confirming that individuals/firms have complied with CPD and PII requirements;
- Firms that are high risk – some indicators (whether firms hold client money, the type of work they do, the type of clients they have, their financial position etc), could be used to identify firms which impose higher risk than others to regulatory objectives; and
- Trends over time – these could reveal that other parts of regulation are effective or ineffective (especially in the context of regulatory change), how work types change over time (potentially revealing firms moving beyond their areas of competence) and new areas of emerging risk.

It is also possible that information returns serve as a prompt for firms to undertake activities e.g. if firms have to confirm that they have PII in place or have completed CPD hours, this may cause them to make sure that they have in fact met these regulatory requirements.

### *Information from barristers*

Until now, information systematically obtained from barristers has been limited to:

- Annual renewal of practising certificates: This requires that barristers confirm contact details, practising status and entitlement to exercise reserved legal activities, completion of CPD hours, presence of PII, and complete a declaration of truth; and
- Chambers monitoring questionnaires: The BSB sent monitoring questionnaires to Chambers in 2010 and 2012. In 2010 the questionnaire covered all regulatory requirements on Chambers and in 2012 it focussed on money laundering and complaints handling.

The BSB has indicated that it intends to conduct similar Chambers monitoring every 3 years.<sup>40</sup> They also intend to conduct thematic information gathering.

### *Information from solicitors*

As with barristers, information from solicitors is gathered through:

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<sup>40</sup> BSB, The development of a risk-based approach to supervision, paragraph 36, available from [www.barstandardsboard.org.uk/about-bar-standards-board/consultations/open-consultations/](http://www.barstandardsboard.org.uk/about-bar-standards-board/consultations/open-consultations/)

- Annual renewal of practising certificates: This requires that solicitors provide contact details and details of where they are practising, whether they are members of other legal professions (e.g. a barrister or qualified beyond England and Wales), work categories, languages, whether the solicitor wishes to have conditions on their practising certificate removed, questions of character, questions regarding financial difficulty, whether they have completed CPD hours, provider of indemnity insurance, whether they are locums, whether they wish a Welsh language certificate,<sup>41</sup> and
- Annual information from firms: This includes organisation details, whether firms hold client money and if so balance information, contact names for various roles, details of indemnity insurance, details of any introducers/referrals and the proportion of turnover from this source, fee sharing arrangements, details of any external influence or involvement in the firm, other activities of a sole practitioner, number of legally qualified and non-legally qualified fee earners, character and suitability, negligence claims, details of complaints received, turnover details, reliance on single income source, obligation to report financial difficulties, areas of work, proportion of work funded by legal aid, details of other offices.<sup>42</sup>

#### *Linking information to regulatory risks*

A significant gap at present is that regulators have not systematically set out the link between risks to regulatory objectives on one side and the gathering and use of information to assess these risks on the other. Since risks vary across the legal services market as set out in the Oxera framework, this should affect the information that regulators seek to gather. In some places the link between risk and information is fairly obvious e.g. loss of client money is a very significant risk which links clearly to gathering information on whether firms hold client money and, if so, how much. In other cases, a more complex logic would need to be set out. The absence of a systematic approach is likely to mean that:

- Some information may be gathered which may not be needed – for example, solicitors are asked to list applicable languages which could be useful for marketing but it is unclear that it is needed for regulation; and
- Some information may not be gathered which may be needed – for example, barristers do not provide information to the BSB on the type of work they do or who they do it for despite risks varying across segments.

Further, much less evidence is available on whether, and how, information is subsequently used after it has been gathered. Since it seems likely that risk-based approaches to regulation will change, and probably increase, the amount of information being gathered, justifying the need for this information is likely to be important not only to show proportionality but also in order to engage with the profession that faces costs from providing it.<sup>43</sup> The SRA is commencing a review of the

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<sup>41</sup> SRA Completing the form: Renewal of practising certificate 2012/2013 (RF3(R) guidance notes).

<sup>42</sup> SRA Form RF1 2012-2013 Application for renewal of practising certificates/registration s2012/2013.

<sup>43</sup> This is not to say that precise details would need to be disclosed, but evidence of how information has been used to advance regulatory objectives would be of benefit to the market as a whole.

information collected and how it is used and its R-view programme aims to develop and implement the SRA's risk framework by the end of 2013.<sup>44</sup>

### *Cost of providing information*

Unlike many of the other issues considered in this report, the cost side of information provision is central and therefore this section has a slightly extended discussion on costs. The provision of information to regulators is unlikely to affect competition or market structure unless the fixed costs and time needed are so substantial as to cause problems for small firms. While competition will be unaffected, the costs of providing information are ultimately passed on to consumers through higher prices and therefore minimising these costs is desirable.

Relatively little information has been gathered on costs which usually need to be assessed on both a one-off and on-going basis. Considering one-off costs is particularly important in the context of changing regulatory approaches because changing systems tends to impose relatively high costs in comparison to the annual process of providing the same type of information each year. During the change to Outcomes Focused Regulation the SRA did gather some high level evidence on the cost of providing information which was estimated at around £1,700 per firm.<sup>45</sup> Evidence does not appear to be available on the cost of practising certificate renewal for either barristers or solicitors, or on the cost of Chambers monitoring.

As well as considering the overall cost for firms to provide information, proportionality requires that regulators take into account whether there are alternative, more cost-effective, ways to gather this. For example:

- Examining the method of collecting information - both the BSB and SRA have moved to an online system of practising certificate renewal which is likely to reduce on-going costs for some firms and regulators (and therefore fees passed on to the regulated community);
- Designing information requests to utilise information that firms already have such as requiring copies of bank statements where a financial viability assessment is needed;
- Considering whether proxies for the ideal information exist – for example, funding through legal aid may be a good, but not perfect, proxy for vulnerable clients, but gathering evidence on which firms received legal aid payments may be more cost effective than requiring all firms to incur costs identifying the proportion of their business which serves vulnerable clients. In addition, existing reliance on legal aid may help identify firms expected to come under financial pressure given reductions in legal aid funding;
- Examining whether alternative information sources exist - whether firms have insurance cover could be better revealed from insurers than from firms. In particular, it seems unnecessary to confirm this with 13,000 barristers if it is confirmed with Bar Mutual. Indeed, the latter checks whether barristers actually have insurance rather than say they have it; and
- Considering whether there are specific details of information requests which are unduly costly – collecting client money balances is important in assessing risk, but if there is strong correlation between the largest, smallest and average statement balance on a monthly

<sup>44</sup> SRA, Strategic plan 2013-15, available from [www.sra.org.uk/sra/strategy.page](http://www.sra.org.uk/sra/strategy.page).

<sup>45</sup> SRA, Delivering outcomes-focused regulation, policy statement, November 2010, Annex D.

basis (as currently collected) it may be sufficient to collect one of these especially if the marginal cost of one of the three is high.

In general, there does not appear to have been a systematic consideration of alternative sources for gathering information in the most cost effective manner.

### *Summary*

**Table 7: Regulatory information returns**

	<b>Regulatory information returns</b>
<b>Purpose of regulation</b>	Ensure compliance with other regulations, identify trends and emerging risks.
<b>Extent and variation in risk by segment</b>	Information should be used to assess the extent and variation in risk by segment, but currently little variation observed.
<b>Variation between regulators</b>	SRA requires far more extensive information compared to BSB.
<b>Targeted and effective regulation</b>	No clear mapping between risks and information gathered.
<b>Market impacts beyond those under purpose</b>	Cost/time could affect small firms preventing entry or distracting them from advising clients.
<b>Costs</b>	Cost of complying with new information gathering processes and regulator cost of analysing the information.

### *Evidence required to assess proportionality*

There is a range of ideal evidence which would be required in order to assess whether existing approaches to regulatory information returns are proportional:

- Mapping of risks and information needed to assess these different risks – this would require systematic consideration of the different risks faced in legal services, and the appropriate information needed for assessment. It also links closely to supervision (considered in the next section). In the absence of this step, further evidence gathering may identify the cost of providing regulatory information returns but not the benefit and therefore it would not be possible to draw conclusions on their proportionality;
- Estimates of the cost of providing information to regulators – limited information currently exists. As a starting point, information from other sectors could be used to provide a rough estimate of likely costs. With new information requests likely, compliance cost information should be gathered, with concern for the practicality of obtaining specific pieces of data; and
- Assessment of whether regulatory information returns provide a prompt to act – this could include examining CPD hours to see whether a disproportionate number arise in the run-up to practising certificate renewal and whether there are a disproportionate number of updates to contact personnel through the annual return compared to the rest of the year. In some cases it may be difficult to distinguish between the desire to meet regulatory requirements and the prompt effect (e.g. both effects could result in individuals doing lots of CPD at the last minute) but it would provide an upper bound on the prompt effect.

## 2.6 Supervision

Supervision is aimed both at ensuring that firms comply with regulatory requirements as well as identifying where new risks may be emerging. It typically involves monitoring of a more on-going nature compared to enforcement which is more reactive to problems that emerge. In the absence of supervision there is little to stop firms from claiming to be compliant in the hope that they will not be caught through enforcement mechanisms. Similarly, insufficient supervision may mean that regulators are deficient in their understanding of how firms conduct business, potentially allowing detriment to emerge.

Historically, relatively little weight has been given to supervisory approaches in legal services, with reliance instead on rules and enforcement mechanisms to seek to ensure compliance. Both the SRA and the BSB are adapting their supervisory approaches with the associated intention that engagement with firms can occur at an earlier stage compared to when relying on enforcement mechanisms alone. Information gathering plays an important role in this with regular information returns (considered in the previous section) a component of it.

### *Barrister supervision*

Historically, the BSB has conducted supervision through the monitoring of CPD requirements, investigations launched by the Professional Conduct Committee, random visits to Chambers in respect of pupillages and, in recent years, the Chambers Monitoring questionnaire.

The BSB is currently consulting on the development of a risk-based approach to supervision.<sup>46</sup> As well as gathering information from its existing activities and from the Legal Ombudsman, the proposed triennial Chambers monitoring questionnaire is intended to be the main interaction with those Chambers deemed to be low-risk. Of crucial importance to this is therefore to know how to define and measure risk. The BSB has identified a number of factors that increase or decrease the likelihood of non-compliance as well as factors which affect the impact that such non-compliance could have. These issues form part of the BSB's consultation.

The BSB also intends that thematic evidence gathering will occur which would encompass all entities that might be relevant to the particular theme being considered (the SRA takes a similar approach). The BSB has suggested that it will seek to minimise the frequency of such projects and to combine different areas in order to reduce the burden on those participating.

### *Solicitor supervision*

The SRA's approach to supervision is more advanced than that of the BSB having started the process of designing its own risk-based approach somewhat earlier and having a more complex set of firms to supervise. The SRA piloted its approach to supervision which appears to have been useful in establishing effective approaches such as the desirability of distinguishing different types of firms. In particular, the largest and most complex firms where business models and issues are likely to be more bespoke are allocated a relationship manager as distinct from smaller firms where business models are more straightforward and issues likely to be more similar across firms.

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<sup>46</sup> BSB, The development of a risk-based approach to supervision, available from [www.barstandardsboard.org.uk/about-bar-standards-board/consultations/open-consultations/](http://www.barstandardsboard.org.uk/about-bar-standards-board/consultations/open-consultations/)

As well as assisting with the design of future supervision, the SRA's pilot study was also useful as supervision itself. In particular it resulted in regulatory and/or disciplinary action in 10.5% of cases (17 firms) of which half are now subject to intervention, intervention has been recommended or conditions on practising certificates have been imposed. The benefit of this for consumer protection is therefore already clear from the pilot study. Further, the pilot was based on a sample of low and medium risk firms suggesting that high risk firms would see a higher proportion of regulatory action required. Results of the pilot study could also help to validate the existing risk ratings and help to direct supervisory resources in the short-term.

#### *Mode of contact*

The SRA's pilot study identified a distinction in the mode of contact used with firms where telephone based discussions led to constructive engagement in comparison to written correspondence which may be perceived more formally. Face-to-face inspections have historically been restricted to situations where there is particular cause for concern and the BSB notes that for barristers this type of investigation has been limited to a few times a year.<sup>47</sup>

Face-to-face supervision is likely to impose greater costs on firms and the regulator (see below) but at the same time provides more opportunity for supervisors to see the reality of how businesses are being run, advice is being delivered and administrative requirements being complied with. The introduction of risk-based supervision by both the SRA and BSB provides the opportunity to target these more costly methods of supervision on firms already identified as risky or for interaction with firms on a regular but infrequent basis (compared to telephone, online and written interaction).

#### *Mapping risks to supervision*

As with the gathering of information from firms, mapping regulatory risks to the supervisory approach is an important step in designing an effective supervisory strategy. A high level examination of the approach to supervision suggests that there may be a number of risks that may not be captured through the current approaches. For example:

- The inability of many clients to assess the quality of advice is one of the key justifications for regulation in the legal services sector yet little in either the BSB or SRA's approach to supervision seems to focus directly on whether lawyers provide high quality advice to their clients. While it is undesirable to prompt an administratively focused, "tick-box" compliance culture to file reviews, this seems a significant gap in regulatory oversight. Crucial to regulators assessing the quality of advice is having supervisors who are sufficiently skilled and experienced in different types of firms; and
- While the authorisation process enables checking of new solicitor firms, there is no equivalent for barristers setting up new Chambers. Potentially this leads to a greater need for supervisory engagement with new Chambers (compared to new solicitor firms). Similarly, there seems to be little distinction between the approach to monitoring existing firms with well-established reputations compared to new firms that have just set up and have no reputation to lose. In respect of holding client money, one of the main monitoring tools is a

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<sup>47</sup> BSB, The development of a risk-based approach to supervision, paragraph 13, available from [www.barstandardsboard.org.uk/about-bar-standards-board/consultations/open-consultations/](http://www.barstandardsboard.org.uk/about-bar-standards-board/consultations/open-consultations/)

report from accountants which is only required 6 months after the accounting period and therefore potentially 18 months after starting a new firm, raising the potential that non-compliance among new firms may not be detected sufficiently quickly.

There does not appear to have been systematic evidence gathered to enable an assessment to be made of whether current approaches are proportionate to risk.

### *Sanctions*

Historically, sanctions have been applied through enforcement mechanisms. However, increased emphasis on supervision raises the question as to whether certain forms of remedial action and redress can arise earlier in the regulatory process. The LSB has already announced that it will be conducting a review of the regulatory sanctions and appeals processes which will cover the current systems, assessment of best practice, barriers to achieving this and options for change.<sup>48</sup> It would be expected that this review would include consideration of the appropriate timing of regulatory actions.

### *Costs of supervision*

Evidence does not seem to be available on the cost imposed on firms for different types of supervision. However, the SRA has measured some of its own costs of undertaking supervision through capturing the amount of time spent in conducting the pilots. One striking aspect of this in respect of relationship managers is that the time spent travelling often exceeded the time spent engaging with firms. This may reflect the majority of supervisors being located in Birmingham but many large firms being located in London. It must be questionable whether such an approach is sustainable under a full supervisory regime or whether greater allocation of staff and firms on a geographic basis would be more efficient.

### *Summary*

**Table 8: Supervision**

	<b>Supervision</b>
<b>Purpose of regulation</b>	Ensure compliance with other regulations, identify trends and emerging risks.
<b>Extent and variation in risk by segment</b>	SRA split out large and complex firms for relationship management due to their high impact if problems arise.
<b>Variation between regulators</b>	BSB regime not yet designed.
<b>Targeted and effective regulation</b>	No systematic mapping between risks and supervisory approach.
<b>Market impacts beyond those under purpose</b>	If unduly costly could prevent entry by small firms due to fixed cost of compliance, risk that timing of significant engagement of interaction with supervisors by small high risk firms could distract them from providing high quality advice to clients.
<b>Costs</b>	Cost of complying with supervisory interaction, thematic reviews and regulator costs.

### *Evidence required to assess proportionality*

<sup>48</sup> LSB Business Plan 2013/14, April 2013.



There is a range of ideal evidence which would be required in order to assess whether existing approaches to supervision are proportional:

- Consideration of whether assessment of the quality of advice is best achieved through a proactive supervisory process or reactive enforcement mechanisms – the boundary between supervision and enforcement is an overarching issue but since supervisory approaches are under development it seems appropriate to capture this issue here. Similarly, consideration could be given to whether the type of remedial action and redress that is currently limited to very formal, process driven enforcement actions could be brought earlier into the supervisory process. Examination of PII claims and case study evidence could help to establish the proportion of firms with PII claims which later give rise to more significant risks of poor advice and whether these are usually captured in the supervisory process;
- Mapping of risks and supervision – as with information gathering this would require systematic consideration of the different risks faced in legal services, how these are addressed by other parts of the regulatory regime and therefore the best supervisory approach. This would require an in-depth desk-based and interview-based review. Where possible, existing data could be used to identify the extent of detriment from particular risks;
- Cost of complying with supervisory activities including thematic information gathering is currently unknown – as with the cost of providing regulatory information, evidence from other sectors can help to provide a rough estimate of likely costs. With new supervisory approaches expected, compliance cost information could be gathered through bespoke surveys; and
- Consideration of alternative methods of identifying risks e.g. the development of the quality assurance for advocates scheme may represent a more effective manner of ensuring quality of advice for advocates than supervisory file checks, although other types of legal service may be better suited to file checks. Similarly the Bar Business Standard may indicate quality but relying on the decisions of others runs the risk of outsourcing regulation.

## 2.7 Insurance requirements

Legal professionals are required to obtain professional indemnity insurance (PII). There are two main reasons for requiring professionals to have insurance: protecting clients from financial loss (which could be very significant); and protecting the reputation of the legal profession from the behaviour of individual lawyers. In the absence of insurance, clients would still be able to seek redress, but the lawyers may not have funds available out of which they can compensate clients.

Lawyers may also wish to take out insurance to protect themselves against significant loss in the event of giving poor advice. Unless there are problems with the indemnity market this would not require intervention. As such it is important to note that not all of the costs of insurance should be considered to represent regulatory driven costs.

In addition, the nature of much legal advice is that the quality of the advice may only be revealed over time and therefore the compensation may be sought some years later. It is for this reason that PII is required not only during the years of practice but typically for a number of years afterwards.

*Differences in structure of insurance between regulators*

Since 1988, self-employed barristers have been required to obtain PII through Bar Mutual which is a single mutual fund insuring the whole profession with barristers both the insured and insurer.<sup>49</sup> Barristers therefore have no choice in their PII provider although this is similar to other small professions. Bar Mutual's Board of Directors (all of whom are self-employed barristers) rather than the BSB determines the policies and coverage provided through Bar Mutual's PII although it is understood that the BSB can influence these or could make changes through the Code of Conduct if required.

Since 2000, solicitors have been required to obtain PII using the open market with "qualifying insurers" who agree to meet various minimum terms and conditions set out by the SRA;<sup>50</sup> ABSs have the same requirements. In 2010, the SRA commissioned a comprehensive review of the potential models for delivering PII and concluded that retaining the open market model was appropriate.<sup>51</sup>

The CLC uses a master policy in which there is a single source of insurance provision, but this is underwritten by multiple insurance companies (hence unlike with Bar Mutual, the insured are not the insurers). This is noted to show alternative approaches, but is not considered in detail below.

### *Coverage*

Bar Mutual covers all self-employed barristers. It has stated that it is open to the possibility of providing insurance to ABSs regulated by the BSB. The prevalence of BSB-regulated ABSs, whether they choose Bar Mutual and are accepted by it, may have implications for the sustainability of a mutual structure.

Qualifying insurers are not required to cover any particular solicitor. Solicitors' insurance provision currently includes the Assigned Risks Pool (ARP) through which PII is provided to any solicitor which is unable to obtain insurance on the open market. The cost of the ARP rose substantially after the credit crisis (£43 million of claims representing 19% of total premiums in 2008/2009) with these costs shared among all qualifying insurers and therefore expected to be passed on to the profession as a whole. The ARP will close from October 2013 with insurers instead required to extend policies for three months where firms are unable to find alternative cover.<sup>52</sup>

### *Level and cost of cover – barristers*

Bar Mutual determines premiums using a rating schedule based on the type of work undertaken, fee income and the value of cover required. It is unclear why claims history of individuals or Chambers is not taken into account as would be common in other insurance policies. Premiums vary from 0.15% for crime to 5.5% for "Revenue-Non-crown instructions-Non-contentious" with a minimum

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<sup>49</sup> Details on Bar Mutual are available from: [www.barmutual.co.uk/](http://www.barmutual.co.uk/). The operational elements of Bar Mutual are outsourced to a management company.

<sup>50</sup> Between 1976 and 1987, solicitors operated using a "Master Policy" in which there was a single scheme covering the entire profession with the underwriting provided by a number of insurance companies. High claims meant that it was difficult to find underwriters to cover the whole risk leading to a switch to a single mutual fund – the Solicitors Indemnity Fund (SIF). SIF was used from 1987-2000 when high claims led to a shortfall which needed to be recouped from the profession and subsequently led to using the open market.

<sup>51</sup> CRA International, Review of SRA client financial protection arrangements, September 2010. Note that Kyla Malcolm was the lead author of the CRA report.

<sup>52</sup> During the first 30 days can continue to practise, but for the remaining 60 days they may only work on existing instructions. SRA news release, ARP applications remain low for final year, 2 October 2012.

premium of £100 (which most barristers qualify for) and an income cap of £1 million.<sup>53</sup> The minimum value of cover is £0.5 million with barristers able to increase their cover up to £2.5 million through additional payments (typically £100 per additional £0.5 million cover). With gross fees around £2 billion for self-employed barristers and gross premiums £15 million this gives an average premium of around 0.75%.<sup>54</sup>

Top-up cover beyond that provided through Bar Mutual can be obtained from the open market.<sup>55</sup> Bar Mutual has urged members to consider whether they need additional cover beyond the minimum raising the question of whether the minimum level of cover is appropriate.

Bar Mutual also operates a “premium deferral” where a proportion of premiums (currently 20%) is not paid unless, and until, Bar Mutual requests it in the event of substantial unexpected claims for the fund as a whole.<sup>56</sup> Waiving the right to these deferred premiums occurs many years later e.g. the 2006 premium deferral was announced in 2013. Whilst this approach prevents Bar Mutual from building up unnecessary reserves it is unclear whether barristers make provision for these premiums and therefore whether this approach would be effective if such premiums were required to be paid.

#### *Level and cost of cover – solicitors*

Qualifying insurers can set premiums for solicitors using any appropriate rating factors leading to in-depth application forms. The cost of premiums was around £230 million in 2009/10, approximately 1.4% of gross fees. The SRA requires cover of £2 million for sole practitioners and partnerships or £3 million for limited companies and limited liability partnerships. The previous review for the SRA found no evidence of problems with the level of cover. Top up cover is also available.

When comparing the cost of PII between barristers and solicitors it is important to note that they typically conduct different functions which are likely to lead to different risks. For example, solicitors hold client money, deal direct with consumers and undertake conveyancing transactions which is an area driving a high proportion of PII claims.

#### *Other terms and conditions*

There are a wide range of other terms which would need to be considered in detail in order to assess their proportionality ranging from the inclusion/exclusion of fraud, misrepresentation, failure to pay premiums, single renewal dates, coverage of clerks and pupils etc.

#### *Continuing PII after leaving the profession*

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<sup>53</sup> Insurance premium tax would be due as well, Bar Mutual Rating Schedule 2013, available from [www.barmutual.co.uk/downloads/](http://www.barmutual.co.uk/downloads/).

<sup>54</sup> Bar Mutual Director’s Report and Financial Statements 2012, available from [www.barmutual.co.uk/downloads/](http://www.barmutual.co.uk/downloads/) and Bar Council, Practising certificate fee consultation, available from [www.barcouncil.org.uk/media/174220/pcfconsultation16102012.pdf](http://www.barcouncil.org.uk/media/174220/pcfconsultation16102012.pdf). The calculation does not take into account the cost of top up cover purchased outside of Bar Mutual.

<sup>55</sup> Bar Mutual Chairman’s Report January 2013 and Bar Mutual Renewal Form 2013, both available from [www.barmutual.co.uk/downloads/](http://www.barmutual.co.uk/downloads/)

<sup>56</sup> Bar Mutual Chairman’s Report January 2013, available from [www.barmutual.co.uk/downloads/](http://www.barmutual.co.uk/downloads/). Bar Mutual also has a “stop-loss” reinsurance policy which provides cover in the event of very high claims for the fund.

Since the quality of advice may only be revealed over time, regulators require PII to be in place after lawyers leave the profession.

Retired barristers are entitled to a minimum of £0.5 million of cover free of charge for as long as Bar Mutual continues to provide PII to the practising bar as a whole, although since such individuals receive a benefit from this it is unclear why they do not pay for it. Members who have cover above £0.5 million for any of the three years preceding retirement can purchase six years' run off cover at the highest level of cover received at 75% of the average premium over that period. This can be renewed in three year tranches for 20% of the premium paid for the first six years' cover.

For solicitors there is some evidence that the requirement to have run-off cover for six years after leaving the profession is causing barriers to exit. It is estimated that run-off cover typically costs 2-3 times the level of the annual premium and some concerns were expressed during the SRA's review that solicitors were unable to pay these levels of premiums and therefore unable to exit.

### Summary

**Table 9: Professional indemnity insurance**

	<b>Professional indemnity insurance</b>
<b>Purpose of regulation and extent of risk</b>	Protecting clients from loss from poor advice. Prevent reputational damage to industry.
<b>Extent and variation in risk by segment</b>	Qualifying insurance can use any ratings factor to determine premiums and would therefore be expected to take risk into account as appropriate. Bar Mutual uses fee income and work type; it does not use claims history. Relative simplicity of Bar Mutual model means barristers can do little to mitigate individual risk in a way that feeds through to premiums. Cost and variation in premiums shows extent and variation in risk is substantial.
<b>Variation between regulators</b>	SRA has qualifying insurers whereas BSB requires the use of a single mutual insurance fund (Bar Mutual).
<b>Targeted and effective regulation</b>	Unclear whether single mutual model is appropriate for barristers. Terms set by Bar Mutual not BSB. Unknown whether barristers make reserves for premium deferral. ARP imposes costs on qualifying insurers (passed on to solicitors) that they cannot control.
<b>Market impacts beyond those under purpose</b>	Barristers are unable to obtain insurance with more bespoke coverage or from their choice of insurer. Top-up cover requires two separate policies. Run-off cover for solicitors may be causing a barrier to exit. Differences in prescribed insurance may restrict business models of firms seeking to act across legal services.
<b>Costs</b>	Insurance premiums for solicitors in 2009/10 were £226 million or 1.4% of gross fees; for barristers in 2012 they were £15 million or 0.75% of gross fees. SRA/BSB administrative costs associated to design of schemes.

### Evidence required to assess proportionality

There is a range of ideal evidence which would be required in order to assess whether existing rules related to PII are proportional:

- Examination of whether SRA decisions in the light of the previous review were proportional – requires a review of subsequent decisions;
- Consideration of whether Bar Mutual remains an appropriate model for self-employed barristers – in depth review of operation of Bar Mutual, relative expense of it, comparison with other professions of similar size (which often do not use the open market), incentives for risk mitigation. Similar considerations would be needed in connection with the CLC Master Policy;
- Consideration of whether barristers make reserves for premium deferrals and whether this is non-trivial – value by barrister type should be available from Bar Mutual, use of a survey targeted at firms with non-trivial premiums;
- Number and value of claims against barristers who have left the profession to assess whether this cover should be free – should be available from Bar Mutual;
- Examination of the proportion of barristers with top-up cover at different levels, number and value of claims where there is insufficient cover and proportion of these cases where barristers were unable to pay claims - should be available in part from Bar Mutual and also from insurers offering top up cover;
- Evidence on whether ABSs will join / be accepted in relevant schemes – discussions with ABSs, Bar Mutual, qualified insurers; and
- Consideration of whether different insurance requirements across legal services impose structural restrictions on business models where firms wish to combine activities – discussions with firms on borderline of multiple regulators, Bar Mutual, CLC Master Policy brokers and insurers, qualified insurers.

## 2.8 Separate client accounts

The SRA requires that solicitor firms hold client money in a separate account to firm money that is used for running the business.<sup>57</sup> The aim of this is to ensure that client funds are protected in the event of bankruptcy since otherwise all funds (including client funds) would be available to distribute to creditors.<sup>58</sup> Hence this addresses an asymmetry of information between consumers and firms regarding the quality of the firm itself (as distinct from the quality of the firm's advice). These rules may also assure regulators that the on-going treatment of client money is appropriate. The SRA also operates the Compensation Fund which similarly aims to protect clients from loss of funds (see next section). Along with poor quality advice, detriment from loss of client funds appears to be one of the most significant risks in legal services. The SRA has been considering some aspects of client money during part of its review of conveyancing.<sup>59</sup>

### *Differences between regulators*

While the SRA requires separate client accounts, the Bar Council's Code of Conduct prohibits barristers from handling client funds.<sup>60</sup> Instead, barristers have relied on solicitors for such functions, but this may have prevented the direct use of barristers in cases where client funds are transmitted,

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<sup>57</sup> SRA Accounts Rules 2011, Rule 1.2a.

<sup>58</sup> Separate client accounts may also help with firms' own administration in which case they may choose to use separate client accounts in the absence of regulation (although not necessarily follow all of associated rules).

<sup>59</sup> Legal Futures, SRA mulls making firms that want to hold client money seek permission, 8 January 2013.

<sup>60</sup> Rule 407 of the Bar Council's Code of Conduct.

thereby impacting competition with solicitors. It is possible that this prohibition could detrimentally affect new opportunities which would otherwise result from ABSs.

BARCO is owned by the Bar Council and regulated by the Financial Conduct Authority. It has recently been developed to operate an escrow service in relation to client funds i.e. it acts as an independent third party to receive and distribute funds between transacting parties according to contractually agreed conditions.<sup>61</sup> BARCO can therefore facilitate direct use of barristers while maintaining the prohibition on barristers handling client funds. Barristers, rather than clients, would pay for BARCO with the administration fee capped at £250 per instruction.<sup>62</sup> BARCO has been developed partly in response to desires from international clients to work directly with barristers on international dispute cases. Whilst currently still in the pilot phase, the presence of BARCO is expected to increase competition with solicitors particularly in international disputes and commercial work with other work likely to be included if BARCO proves popular.

#### *Definition of client money*

The SRA categorises a variety of different money as client money (as distinct from office money).<sup>63</sup> This includes money held as a trustee, money for disbursements and taxes, and money received as a benefit paid in respect of a client. It also includes money received as a payment on account of costs although fees paid against bills and fees paid for an agreed fee are categorised as office money. It is unclear whether client money protection is required in the case of payment on account or whether it would be reasonable for such clients facing loss of such money could be treated as creditors of the firm along with other creditors. It is also unclear whether altering this definition would remove any firms from being captured by the client money requirements.

#### *Compliance and administrative burdens*

Although the idea of separate client accounts appears straightforward, in practice there is considerable complexity associated to the rules (with 65 pages of rules testifying to this). While detailed rules may be appropriate, it is also possible that complexity itself introduces risks or that the level of complexity is such that solicitors do not follow these rules.

It is unclear whether client account rules are actually complied with in cases where bankruptcy occurs and therefore whether rules are effective in offering protection in these circumstances. Indeed, there is evidence that solicitors do not all comply with these rules. The SRA notes that accounts inspections make up the majority of visits by their Forensic Investigations Unit which conducted 521 investigations during 2012.<sup>64</sup> Around 50% of intervention cases had breaches of accounts rules, and 38% of cases before the Solicitors Disciplinary Tribunal were to do with breach of accounts rules and client money.

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<sup>61</sup> Bar Council, BARCO – working with the Bar has never been easier. Available at [www.barcouncil.org.uk/for-the-bar/barco](http://www.barcouncil.org.uk/for-the-bar/barco)

<sup>62</sup> The Administration Fee is a deduction which applies on each occasion that money is paid to the barrister under the relevant Standard Framework Agreement. It is set at 2% of the value of the payment subject to a maximum amount of £250. Source: Bar Council.

<sup>63</sup> SRA Accounts Rules 2011, Rule 12.

<sup>64</sup> SRA Regulatory Outcomes Report, December 2012 available from [www.sra.org.uk/sra/how-we-work/reports.page](http://www.sra.org.uk/sra/how-we-work/reports.page)

The SRA is currently engaged in a major thematic piece of work to examine the financial stability of firms. Over 2000 firms are currently facing an assessment of their stability and it is to be expected that this work should identify evidence of relevance to the consideration of compliance with the appropriate separate client account rules.<sup>65</sup>

*Summary position*

**Table 10: Separate client accounts**

	<b>Separate client accounts</b>
<b>Purpose of regulation</b>	Preventing loss of client funds. Prevent reputational damage and market participation risk.
<b>Extent and variation in risk by segment</b>	Very significant detriment where client funds are lost, but this depends on likelihood of failure; hierarchy of creditors; and value of client funds compared to creditors as well as administrative competence of law firms. SRA rules apply across all client money, but individuals worse than corporates at assessing firm risk; client funds likely to represent a higher proportion of assets for individuals than corporates; some work types involve large client funds (conveyancing, disputes, estate administration, family law, personal injury); and client funds likely to be high compared to firm funds for small firms.
<b>Variation between regulators</b>	SRA requires separate client accounts. The BSB prohibits barristers from handling client funds and BARCO set up to facilitate direct access.
<b>Market impacts beyond those under purpose</b>	Structure of competition previously affected by Bar Council prohibition hence should expect to see more direct use of the independent bar in reflection of new freedoms although the overall restriction could still affect competition.
<b>Costs</b>	Costs of operating client accounts, Compensation Fund and BARCO. Cost of auditing client accounts. Value of loss of client funds. Link to cost of compensation funds where these pay out in relation to lost client funds.

*Evidence required to assess proportionality*

There is a range of ideal evidence which would be required in order to assess whether existing rules related to separate client accounts are proportional:

- Total value of client funds transmitted, by type of work, client, firm – it is unclear whether this data is available although it may be possible to collect this data over time. In addition it would be useful to gather data on the number of firms who would not be treated as holding client money if such money did not include payments on account;
- Number of firms that close/fail each year– data should be available from regulators;
- Examination of why firms fail, and whether they have administered client accounts appropriately or whether separate client accounts are actually ineffective in the case of failure – likely to require 10-20 case studies;
- Cost to firms of managing separate client accounts – consideration of the complexity of current rules including examination of which aspects of client accounts rules prove

<sup>65</sup> Legal Futures, Thirty of top 200 on SRA list of financially unstable firms, 13 June 2013.

particularly problematic for firms to deal with, compliance cost survey, existing evidence from other markets e.g. FSA regulated firms;

- Gathering of data on Compensation Fund payments – available from Compensation Fund;
- Examination of whether barristers break client money rules – could be available from BSB related to disciplinary actions;
- Consideration of alternative approaches to handling client funds seen elsewhere – desk research on other sectors and countries, evidence may have been revealed by Bar Council in designing BARCO. Such alternatives could be considered for all client money or for particular sources of client money (conveyancing, probate) or for particular types of firms; and
- Case study on BARCO – Linked to the above, this would include examining set up costs, price of participation, extent of use and types of work which should be available from Bar Council in due course. Desk research consideration of whether new risks are introduced. Quantitative assessment of changes in direct use of barristers would require monitoring over time and changes in market outcomes (quality, price, quantity) will be difficult to observe unless in very specific areas.

## 2.9 Compensation funds

The SRA Compensation Fund (CF) pays out money when clients suffer loss because of dishonesty or failure to account for client money and there are therefore overlaps in the aim of the CF, separate client accounts and PII. Since markets do not insure individuals for their own dishonesty, PII does not cover these risks and consumers would be unprotected from dishonesty in the absence of the CF. The presence of the CF may also protect the reputation of the profession more generally. The SRA conducted an 18-month review of the CF which reported in April 2009. In Autumn 2012 they launched a root and branch review of compensation arrangements expected to last for 2 years.<sup>66</sup>

Barristers cannot hold client money which is why the BSB does not consider a compensation fund necessary.<sup>67</sup> However, it is possible that barristers break client money rules or that their clients could suffer loss due to dishonesty. It appears that there is no regulatory protection in place for this although it is unclear whether such circumstances have arisen.

### *Coverage*

Payments from the CF are made where there has been loss due to dishonesty or loss and hardship due to failure to account for money – individuals who suffer loss are deemed to suffer hardship, whereas corporate clients would need to demonstrate this.<sup>68</sup> This is consistent with individuals being less able to assess the quality of their lawyer compared to corporate consumers. It also provides compensation where practitioners should have had PII cover but did not.

Many of the conveyancing claims against the CF in recent years have been from lenders although as regular and informed users of conveyancers they do not appear to need regulatory protection. However, one concern is that if lenders lose access to CF payments, they could appoint a different

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<sup>66</sup> SRA, Review of the Compensation Fund, Report of the Financial Protection Committee's Compensation Fund Review Working Party, April 2009 and [www.sra.org.uk/sra/how-we-work/compensation-fund-review.page](http://www.sra.org.uk/sra/how-we-work/compensation-fund-review.page).

<sup>67</sup> BSB, Frequently asked questions (Entity regulation and Litigation) available from [www.barstandardsboard.org.uk/media/1446593/entity\\_faqs.pdf](http://www.barstandardsboard.org.uk/media/1446593/entity_faqs.pdf)

<sup>68</sup> SRA Compensation Fund Rules 2011, Rule 3.



conveyancer to individuals (potentially duplicating some costs which would ultimately be passed on to consumers) or could require consumers to choose from a set of conveyancers that the lender had pre-selected. This could radically alter the conveyancing market and therefore would require careful consideration.

In addition, solicitors themselves can claim from the CF (probably in the form of a loan) if they suffer loss because partners or employees have acted dishonestly – it is argued that this cover may encourage individuals to report such dishonesty.<sup>69</sup>

#### *Overall cost of the CF*

Payments from the CF vary around £10-20 million per year with some evidence that they are linked to the economic and property cycles.<sup>70</sup> Fees for the CF were set at £22 million for 2012/13, an increase from £13.5 million in 2011/12.<sup>71</sup> Most claims from the CF relate to where the SRA has intervened in a firm. Contributions to the CF are required as follows:

- All solicitors are required to contribute to pay £92 (£60 in 2011/12) to the CF which is consistent with a view that the CF protects the reputation of the profession as a whole; and
- All firms that have held client money during the previous year must contribute £1,340 (£772 in 2011/12) which is consistent with the fact that payouts from the CF relate to misappropriated money.

The considerable increase in the expected value of claims in recent years suggests that further investigation in this area may be necessary.

#### *Risk reflection*

Currently CF contributions are not especially risk reflective and there is nothing that firms or individuals can do to reduce their CF contributions other than to never hold client money. If the additional administrative burden associated to a more complex approach is not unduly expensive, proportionality might be expected to lead CF contributions to be risk reflective linking contributions to the risks from issues such as different types of work, firms and the value of client money compared to the value of office funds. Information on the number of claims is available which identifies that the top four claims in 2012 were “General client money” (44%), Stamp Duty Land Tax (13%), Probate(10%) and Mortgage fraud (10%) although information is not published on the proportion of claims by value.<sup>72</sup> It is no particular surprise that conveyancing and probate related claims are amongst the highest given the prevalence of holding client money in these areas as well as the frequency of these types of work. The credit crisis is also believed to have led to substantial increases in conveyancing claims.

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<sup>69</sup> SRA Compensation Fund Rules 2011, Rule 6.3.

<sup>70</sup> CRA International, Review of SRA client financial protection arrangements, September 2010. SRA Regulatory Outcomes Report, December 2012 available from [www.sra.org.uk/sra/how-we-work/reports.page](http://www.sra.org.uk/sra/how-we-work/reports.page)

<sup>71</sup> SRA fee policy 2012/2013 and 2011/12. Note that the 2010/11 contribution was only £2.1million reflecting high reserves previously built up.

<sup>72</sup> The SRA notes that “General Client Money” relates to money paid on account to firms that the SRA subsequently intervenes in and/or to costs paid to a regulated firm where no work was done. Sources: SRA Summary of Performance Measures and Statistics, December 2010 and SRA Regulatory Outcomes Report, December 2012 available from [www.sra.org.uk/sra/how-we-work/reports.page](http://www.sra.org.uk/sra/how-we-work/reports.page)

*Summary***Table 11: Compensation funds**

	<b>Compensation funds</b>
<b>Purpose of regulation</b>	Protect clients from loss due to dishonesty or failure to account for client money.
<b>Extent and variation in risk by segment</b>	Loss of client money a very serious risk. Individuals are less able to assess law firm quality than corporates or lenders. Some distinction in level of protection by client type applies.
<b>Variation between regulators</b>	SRA has the CF; BSB does not.
<b>Targeted and effective regulation</b>	Focused on financial loss, may provide unnecessary protection to lenders, contributions may be insufficiently risk reflective.
<b>Market impacts beyond those under purpose</b>	Lenders may impose insufficient quality checking due to their regulatory protection hence may lead to total claims being higher than otherwise, but removal of CF access would need assessment as it could radically alter the conveyancing market.
<b>Costs</b>	£22 million in 2012.

*Evidence required to assess proportionality*

There is a range of ideal evidence which would be required in order to assess whether existing rules related to compensation funds are proportional:

- Assessment of circumstances in which barristers could cause clients loss due to dishonesty – bespoke desk research taking into account relevant trends to direct access;
- Consideration of the interaction with supervision and enforcement as earlier identification of problems and more rapid intervention could reduce claims against the CF;
- Examination of appropriate funding methods for the CF – desk research along with evidence from the CF in order to assess the practicalities of increased complexity such as risk reflective funding;
- Assessment of client access – evidence from the CF regarding claims from different types of clients, desk research and interviews to understand the implications from altering client access (e.g. only allowing claims from individuals and no lenders). This would need to include consideration of unintended consequences (lenders limiting the conveyancers that individuals could use, lenders claiming through individuals); and
- Consideration of alternative methods to a compensation fund – desk research on other sectors (including CLC regulated conveyancers) and countries for alternative methods of protecting client funds and overlap with separate client accounts (e.g. similar models to BARCO) could remove the need for the CF altogether. The number of claims related to “General client money” where money is paid on account and work not done may be better addressed through consideration of whether this should be within the definition of client money. These issues will also help to analyse concerns that in some cases high set up costs for compensation funds may prevent their development.

Other than the first bullet, much of this evidence may result from the SRA’s CF review.

## 2.10 Enforcement mechanisms

As highlighted in section 2.6, enforcement is more of a reactive approach, intervening when things have already gone wrong, while supervision can be more proactive in intervening before this point. However, enforcement nonetheless plays an important role in ensuring that firms actually comply with rules. At the most simple, if rules are not enforced, then firms can ignore rules with little fear for the consequence of doing so, whereas enforcement mechanisms add credibility to rules such that firms are more likely to comply.

There is not always a clear distinction between whether actions represent part of the supervisory process or the beginning of enforcement action. Indeed, the SRA's enforcement strategy recognises this link between supervision and enforcement as well as the variety of different approaches that could be taken to enforcement according to the nature of the concern. For example, the SRA notes that advice may be more effective in raising standards than a formal sanction, agreed compliance plans could be used and that agreed settlements could lead to quicker resolution of problems than formal proceedings.<sup>73</sup> This rest of this section mainly focuses on the more formal disciplinary component of enforcement.

### *Disciplinary tribunals*

Both the BSB and the SRA operate disciplinary tribunals as the primary method of applying sanctions to firms that fail to meet regulatory standards.<sup>74</sup> Perhaps unsurprisingly, the tribunals are subject to various detailed procedural rules for assessing breaches of regulation. Unlike many other regulators, however, both the Bar Tribunals and Adjudication Service and the Solicitors Disciplinary Tribunal (SDT) are independent of the regulators themselves. While this prevents the perception that each regulator is both prosecutor and judge, this may constrain regulators from imposing sanctions for certain relatively minor offences in a timely manner.

The status of the disciplinary tribunals as bodies which are independent of regulators also have implications for whether those regulators (or indeed the LSB) can bring about change to the tribunals if further investigation identifies areas of disproportionality.

### *Scope of sanctions available*

Multiple sanctions are available to disciplinary tribunals ranging from formal reprimands, fines, additional CPD requirements, prohibition from certain activities, suspension to disbarment / being struck off.<sup>75</sup> The level of fines that could be imposed is £15,000 for barristers although the SDT can apply unlimited fines. Higher fines would be expected to have a higher deterrent effect although simply increasing fines may not be the best response to more serious failures as alternative sanctions such as suspension or disbarment may be more appropriate.

Some inconsistencies also arise in the current sanctions processes in respect of different types of firms with ABSs subject to different standards compared to traditional law firms (e.g. civil compared

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<sup>73</sup> SRA enforcement strategy, January 2011 available from [www.sra.org.uk/sra/strategy/sub-strategies/sra-enforcement-strategy.page](http://www.sra.org.uk/sra/strategy/sub-strategies/sra-enforcement-strategy.page)

<sup>74</sup> Determination by consent in which barristers agree to sanctions without the need for a full disciplinary tribunal is also possible.

<sup>75</sup> The Solicitors Disciplinary Tribunal, Guidance Note on Sanctions and Council of the Inns of Court Sentencing Guidance: Breaches of the Code of Conduct of the Bar of England and Wales.

to criminal standards of proof). As noted in section 2.6, the LSB has already committed to reviewing these issues.

#### *Time scales*

Although interviews did not identify concerns with the need for enforcement, previous work on PII identified regulatory failure relating to the time taken to close firms down. This issue was also raised in interviews with the suggestion that the practicalities of enforcement may not be as effective as they could be:

- The SRA's Litigation and Legal Advice Unit (LLAU) is responsible for preparing a case for issue at the SDT. On average the LLAU took just over 6 months to do this (although investigations would predate this time) and the SDT heard the case in an average of 10 months during 2012 (against a target of 6 months). There was also suggestion in interviews that earlier focussing of breaches to be considered at the SDT could be beneficial for both timescales and costs;<sup>76</sup> and
- Although based on a small sample, it is notable that of the 15 different barristers who faced hearings in early 2013, 10 of them (67%) related to offences in 2010 or before with only 5 relating to more recent offences.<sup>77</sup> From published information it is not possible to tell the extent to which delays reflect the identification of problems or in bringing cases to hearings.

Overall there are considerable time lags involved in disciplinary proceedings. Given that 27% of cases at the SDT lead to a solicitor being struck off, and a further 19% lead to the solicitor being suspended (around a third suspended indefinitely), these delays could be highly detrimental to clients.<sup>78</sup> While ensuring due process is important, it is unclear whether this is currently appropriately balanced against the need to protect consumers.

#### *Operational effectiveness*

The SDT's annual report states that it sat on 260 days but lost 30 hearing days due to late adjournment applications. 20% of these adjournments were from the applicant (i.e. the SRA) while a surprisingly large number of respondents appear to suffer from ill health. The SDT has introduced case management hearings to seek to reduce the number of lost hearing days and it will be useful to monitor the success of this over time.

#### *Public access*

Six applications were made by the public to the SDT and no case to answer was established in each one. Although this is a small number it raises a question as to whether the public should have direct access to the SDT or whether reliance on the SRA bringing such cases is preferable with the public having access to the Legal Ombudsman. It is unclear what the cost of these cases would have been.

#### **Table 12: Enforcement**

<sup>76</sup> SRA Regulatory Outcomes Report, December 2012 available from [www.sra.org.uk/sra/how-we-work/reports.page](http://www.sra.org.uk/sra/how-we-work/reports.page). SDT, Annual report 2011/2012

<sup>77</sup> These represent all hearings leading to punishable disciplinary findings from 1<sup>st</sup> January to 12<sup>th</sup> April 2013.

<sup>78</sup> SRA Regulatory Outcomes Report, December 2012 available from [www.sra.org.uk/sra/how-we-work/reports.page](http://www.sra.org.uk/sra/how-we-work/reports.page)

	<b>Enforcement</b>
<b>Purpose of regulation</b>	Ensure compliance with other rules.
<b>Extent and variation in risk by segment</b>	No explicit variation in enforcement by segment (such variation could be unnecessary if rules themselves vary by segment).
<b>Variation between regulators</b>	Similar approaches between the BSB and SRA.
<b>Targeted and effective regulation</b>	Timescales for enforcement action are considerable.
<b>Market impacts beyond those under purpose</b>	Weak enforcement may lead to persistence of consumer detriment, the costs of which may also be passed to other members of the profession e.g. through increased CF and PII costs.
<b>Costs</b>	Annual cost of the SDT is £1.9 million (an increase from £1 million in 2007); plus costs for SRA/BSB and costs for lawyers involved.

*Evidence required to assess proportionality*

There is a range of ideal evidence which would be required in order to assess whether existing rules related to enforcement are proportional:

- Assessment of timescales – case studies of other similar sectors to establish whether enforcement processes could be more streamlined;
- Consideration of interaction with supervision – examination of whether approaches and sanctions taken in course of supervision could bring benefits in respect of issues such as the time scales over which enforcement arises; and
- Public access to SDT - Further examination could assess the cost of applications by the public, whether the SRA had already investigated these matters, the proportion of cases in which no case to answer was established over a number of years, and whether the public have alternative redress mechanisms in place.

Assessment of timescales could also be done in combination with consideration of the supervision process as earlier identification and resolution of problems through supervision could also benefit enforcement.

### 3 Assessment criteria for prioritisation of future investigation

Having provided a high level consideration of issues which feed into the determination of whether each of the areas of regulation are proportionate, in this Chapter various assessment criteria are applied across all of the issues in order to help to identify a smaller number of these areas to take forward for further consideration.

#### 3.1 Disproportionality

##### *Demonstrable disproportionality*

The first test to consider is whether there are areas of regulation which, having conducted a high level consideration, appear demonstrably disproportionate. Such regulation would include, for example, areas where there is no clear purpose for the regulation and, if present, would represent a prime target for reform. In fact, all of the regulation considered has a justifiable purpose and therefore no issue has been identified which would necessarily be taken forward on this basis.

##### *Potential disproportionality*

All ten of the areas considered have evidence gaps which would need to be filled in order to be confident about whether or not regulation is in fact proportionate. In most cases this is because there is a lack of sufficient evidence on which to base any conclusions regarding proportionality rather than because of evidence of disproportionality:

- Initial education and training standards impose a barrier to entry to the profession and impose non-trivial costs on individuals. The main barrier arises at the training contract/pupillage stage which interacts with the business decisions of firms/Chambers. At the same time, this stage has no objective assessment and firms/Chambers have little incentive to prevent qualification of individuals when they have no obligation to take on the individuals raising the possibility that entry standards could be too low. This stage is also subject to price regulation (one of the most interventionist forms of regulation) through setting minimum salaries. There are also a large number of administrative requirements which impose costs onto the system as a whole.
- Authorisation acts as a barrier to entry although does not appear to unduly prevent entry in general. With respect to ABS authorisation, only the SRA and CLC are licensing authorities. There are concerns about the length of time taken to gain authorisation and the complexity of the process but the SRA has committed to making changes in this area. These issues may be limiting entry from the very source from which innovation is expected. Conversely, there is some evidence of standards being too low in terms of the experience needed before running a firm or operating as a sole practitioner.
- The separate business rule is applied to solicitor firms on the grounds of consumer protection and preventing confusion. However, it may distort competition over non-reserved activities and while the SRA's waiver policy may limit this distortion in some areas, it may also lack transparency. Underlying the question about the proportionality of the SBR, however, is a more significant question about the boundary of reservation. The removal of the SBR could radically reduce regulatory oversight, reshape the regulated community and have associated implications for regulators and regulatory fees.

- There is limited concern regarding consumer disclosure other than in relation to complaints, although little assessment has been done to establish whether disclosure actually works or is proportionate. There have been suggestions that complaints disclosure requirements are not working effectively in relation to work referred by solicitors to barristers.
- Effective regulatory information returns should show a clear link to underlying risks and the use of information gathered although this has not been set out in a systematic manner raising the potential that such returns are not proportionate. Little evidence is available on whether similar information can be gathered in more cost effective ways or on the cost of providing information to regulators more generally.
- Supervisory processes are new in the legal sector with the SRA's approach more advanced than that of the BSB. As with regulatory information provision, a systematic mapping between risks and supervision has not yet occurred. In particular, there does not appear to be a clear focus on the quality of advice which is one of the key risks for consumers. Evidence on the cost of supervision for firms has not been gathered.
- The SRA has conducted detailed research on professional indemnity insurance enabling questions of proportionality to be examined, but this has not occurred for the BSB (or other ARs such as the CLC). A single mutual model prevents barristers from sourcing insurance from elsewhere, and also necessitates two policies where top up cover is required. It is unclear whether this model is appropriate (similar models are observed in small sectors) and it is surprising that the terms and conditions are set by Bar Mutual rather than the BSB.
- Separate client accounts are required by the SRA in order to protect client funds (loss of which is one of the most significant risks for consumers), however, it is unclear whether client account rules are actually complied with in cases where bankruptcy occurs and whether the complexity of rules itself introduces risk. BARCO has been developed in order to facilitate the direct use of barristers and may therefore be pro-competitive.
- The SRA Compensation Fund pays out when clients suffer loss due to dishonesty or failure to account for client money. It covers all clients (including those who are well informed and may not need regulatory protection) and contributions to the Compensation Fund may not be risk reflective although making them risk reflective would increase administrative complexity. Since barristers cannot hold client money, the BSB does not consider an equivalent fund necessary – it is unclear whether circumstances have arisen in which clients have suffered loss due to this.
- Enforcement mechanisms both enable sanctions and redress when things go wrong, but also act as a method of gaining compliance with rules. Solicitors and barristers face independent disciplinary tribunals with wide-ranging powers although this may constrain the regulators themselves from taking action and few individuals are directly affected. The time taken for enforcement processes is often considerable and although this may partly reflect delays in identifying problems, there are also concerns that insufficient focussing of cases may lengthen timescales and increase costs.

Overall, the evidence gaps indicate that all of these areas of regulation would benefit from additional investigation to at least some degree.

### 3.2 Screening criteria

The next set of issues represents a series of criteria which are applied to each of the ten individual aspects of regulation in order to determine the priorities for further investigation. There will, inevitably, be a trade-off between these criteria in some cases.

#### *Controversy*

There is one issue which stands out compared to others regarding the level of controversy that surrounds it. The SBR divides opinions between the LSB on one side and the SRA, Legal Services Consumer Panel and representative organisations on the other side. The fact of this controversy suggests that this could be an area in which further objective evidence could be of assistance in assessing whether the existing approach is proportional. Furthermore, the consequence of change could be very substantial indicating that careful consideration is required.

#### *Potential effects of rules*

Regulation can bring about different types of effects on the market which is regulated. Some rules may simply impose costs but bring no other impacts in terms of the structure of the market (beyond ensuring the desired behavioural change from the rule itself), while other rules may impact the way in which competition arises in the market. Supervision and enforcement issues are somewhat different because they help to ensure compliance with all rules, and therefore the other eight areas are considered below:

- Some rules bring primarily compliance costs – regulatory information returns, separate client accounts (solicitors), and the Compensation Fund (in the absence of risk based contributions); and
- Other rules may bring market impacts such as:
  - Barriers to entry – education and training, authorisation;
  - Structural changes to competition – SBR, client money ban (barristers); and
  - Behavioural effects – consumer information disclosure (if it changes consumer decisions), PII where barristers are constrained in their choice and where solicitors face prices which encourage risk mitigation.

In general, rules which have market impacts rather than simply compliance costs are more likely to give rise to greater concern regarding disproportionality because the potential consequences of this tend to be more serious on market outcomes. On this basis, regulatory information returns, separate client accounts (solicitors), and the Compensation Fund would not be prioritised.

#### *Manner of engagement with regulation*

Many of the issues considered affect the whole of the regulated market although may do so in somewhat differing ways. For example:

- initial education requirements apply to all individuals and authorisation to all solicitors firms. These are one-off requirements although CPD and renewal of practising certificates are on-going measures;
- the SBR applies only to solicitors firms and affects the initial business model design and then applies on a continuous basis;



- consumer information disclosure requirements apply across the market in an on-going manner for each new client relationship;
- regulatory information returns and the Compensation Fund all require annual interactions to fulfil the regulation;
- PII leads to annual interactions to fulfil requirements but risk-based premiums may have continuous implications and claims will give rise to particular interactions;
- supervision requirements will involve a combination of firms that face annual or even less frequent engagement with the regulator, some that face irregular engagement through thematic reviews and others that face almost continuous interaction;
- separate client accounts rules apply to all solicitors firms that hold client money and then apply on a continuous basis for all client money received whereas all barristers are prevented from holding client money at all; and
- enforcement mechanisms apply only to those individuals or firms that are investigated although their deterrent effect will stretch across the whole market.

The greater the proportion of the market affected by the rule and the greater the level of engagement needed with the rule, the greater any overall impact of disproportionality will be. On this basis, some aspects of enforcement mechanisms, regulatory information returns and the Compensation Fund would not be prioritised.

#### *Potential inconsistency across legal services*

Taking into account the LSB's role, it could be particularly useful to look at some rules which apply differentially across the ARs and thereby impact competition between providers in different regulatory communities.

For example, in connection with the provision of consumer information, it is clear that the role of information alters in the context of referred barristers compared to where barristers are directly engaged by consumers. This raises the possibility that the most effective method of delivering information about barristers could in fact be through the solicitors who refer them rather than through the barristers themselves. The current regulatory structure may hinder this since it is not part of the SRA's remit to ensure that information requirements imposed by the BSB on barristers are fulfilled. This could therefore be an issue for which the LSB is particularly well suited to examining.

It is unclear how Bar Mutual will engage with any BSB-regulated ABSs and differences in insurance may restrict businesses seeking to act across legal services. A similar issue may arise in respect of the CLC master policy.

In addition, in the area of sanctions and redress, different standards apply across different types of firms (ABSs versus traditional law firms). As well as the inefficiency of running multiple different systems, differences between systems will be increasingly problematic if business models increasingly develop which operate across the whole legal services market.

On the basis of this criterion, complaints related consumer information disclosure, insurance requirements and enforcement should be prioritised.

*Existing evidence*

Where no, or very limited, primary research has been done in the past, any research could represent an advancement on existing knowledge. In particular, there is little evidence on the impact of consumer disclosure in legal services, the cost of complying with regulatory information requests, the cost of supervision, the cost of separate client accounts and the potential impact of removing the SBR. In addition, the mapping of underlying risks to the regulatory framework is also lacking in a systematic manner which particularly affects information requests and the supervisory process. This would tend to prioritise these issues.

By contrast, it is not useful to revisit any areas of regulation where ARs have already sought to implement the style of regulatory consideration that the LSB is seeking to encourage (unless lessons from one AR can be applied to others). Hence, within the area of PII, the fact the SRA conducted research to ensure that its requirements were appropriate would suggest SRA requirements would not need to be reconsidered for the SRA although similar in depth research has not been conducted in respect of other ARs.

Similarly, where evidence is already in the process of being gathered, there is little advantage in replication as long as these reviews cover the necessary issues. For example, the LETR is due to report in June 2013 and many of the issues raised and desirable evidence set out in the education and training section would be expected to result from that review. Similarly, the SRA has already started a review of its Compensation Fund.

On this basis, education and training, SRA PII requirements and the Compensation Fund would not be prioritised.<sup>79</sup>

*Timing*

It is appropriate to consider whether now is the best time to examine certain issues or whether some are better left for a few years in order to see how they develop.

In respect of ABS authorisation, only the SRA and the CLC are currently licensing authorities with the BSB intending to apply to become one so. While concerns regarding delays that arise with the SRA's approach have been identified, the SRA has committed to making changes in its authorisation regime. Since regimes are now in place for the SRA and the CLC, it may now be appropriate to observe how they function over the next couple of years in order that both regulators and applicants are more used to the process before any follow up proportionality work is conducted. Furthermore, with the BSB required to apply to the LSB to be a licensing authority, there could be perceived conflicts of interest if the LSB conducts research into proportionality in order to aid the design of the BSB's regime which the LSB then licenses.

In respect of supervision, the question of timing is more complex as the SRA has already piloted its supervisory regime while the BSB is still consulting on various issues surrounding its approach. In respect of the BSB at least, it would seem that now is a very valuable time to map out the underlying risks according to the Oxera framework in order that supervisory processes and information

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<sup>79</sup> It is unclear whether the SRA's consideration of separate client accounts during its review of conveyancing would cover broader issues on client accounts. Hence this is not been included in this section.

gathering is focused on the factors that seem most likely to affect risks to regulatory objectives. Since changing approach often imposes considerable cost, it is usually preferable to take sufficient time to do this at the beginning of a new approach rather than to have to make substantial changes later. However, this argument would rely on such consideration happening soon since there is only a short period of time before the BSB's supervision will be in place. Once it is in place, then it is likely that it would be preferable to review it after three years have elapsed and the Chambers monitoring scheme has been through another round.

The current economic climate and associated closures of firms may lead to a more imminent concern about the compliance with the complexities of separate client account rules which could favour early consideration of these issues. This would need to be balanced with the fact that BARCO has only just been developed and assessing its impact would need to allow sufficient time for it to have been well used suggesting delay until the extent of its use and any emerging risks can be identified. Although not ideal, it would be possible to consider some issues (such as alternatives from other countries and sectors) and to review SRA rules and those of other ARs before the equivalent consideration of BARCO.

This criterion would favour prioritising separate client accounts and, if started quickly, BSB supervision, but not prioritising authorisation.

#### *Feasibility of research*

When setting out priorities for further investigation, it is important to ensure that it is both feasible to gather the relevant evidence and also to bring about change should that be appropriate:

- The SBR interacts tightly with the definition of which services are reserved. It may be the case that disagreements on the current extent of reservation (itself not obviously having been subject to a proportionality test) are in part responsible for differences in opinions on the benefits or otherwise of the SBR. If this is the case then examining the SBR in the absence of resolving issues to do with reservation will leave the bigger questions answered. Indeed, future investigation of the SBR alone would continue to face the issue that it may be undesirable to remove the consumer protection which arises from regulation in areas which have not been reserved but perhaps ought to be.
- Gathering information on PII issues relating to barristers would be highly dependent on the engagement with Bar Mutual which holds the great majority of information needed to be able to assess proportionality. Similarly, information relating to the CLC's master policy (which would be included in wider research on PII) would be dependent on engagement with the insurers and brokers who assist with the design of the master policy.
- In order to assess the functioning of the client money rules, data would need to be gathered on the extent to which firms hold client money and from what sources. While the SRA does gather information on client money balances, evidence on its sources may not be available and such information may take time to obtain
- The status of the disciplinary tribunals as bodies which are independent of regulators also has implications for whether regulators (or indeed the LSB) can bring about change to the tribunals if further investigation identifies areas of disproportionality.

Before commencing further investigation in any of these areas, it would therefore be necessary to first resolve these issues.

### 3.3 Spread of options

In addition to the consideration of each area of regulation on its own merits, it is also useful to consider the value in having a spread of different issues that are taken forward in future investigation. Given the LSB's role as the oversight regulator, there are benefits for all of the ARs from understanding in more detail the type of consideration that the LSB expects to happen when designing regulation and the evidence that the LSB expects ARs to consider. For this reason, there may be advantages in prioritising some areas at the expense of others in order to demonstrate a methodology of how to approach the issue. Examining a spread of different issues would aid with this understanding across the regulatory landscape. For example, it may be valuable to include:

- the three different types of regulation (rule-making, supervision and enforcement);
- different justifications for regulation (as per the Regulatory Policy Institute), different market segmentations (as per Oxera) and different ARs; and
- issues which have different types of impacts e.g. those that affect entry and the structure of competition compared to those which only impose compliance costs.

It should be noted that if there is only limited concern about the disproportionality of an issue, it would not be appropriate to include an issue in follow on investigation purely for the reason that it would fulfil the desirability of examining a spread of options.

### 3.4 Proposed prioritisation for future investigation

The table below sets out the summary factors determining the degree of prioritisation that should be given to each issue.

**Table 13: Summary factors by issue**

	<b>Summary factors</b>
<b>Education and training</b>	LETR already examining many issues, but ensure that issues highlighted are considered in connection with the LETR.
<b>Authorisation</b>	Limited undue effects on entry other than for ABSs where SRA already committed to improving and CLC only other licensing authority.
<b>Separate business rule</b>	This is an area of controversy where additional evidence should aid regulators in determining the proportionate response. The potential impact of change could be substantial and therefore detailed research is required in order to avoid unintended consequences. It also represents the issue most likely to affect competition.  However, the underlying issues relate to the question of which activities are reserved and this should be considered first or additional research on the SBR alone will still leave regulators unable to determine the proportional approach.
<b>Consumer information disclosure</b>	Little evidence is available on the effectiveness of disclosure. A case study on complaints information would be well defined, provide an example for future research both on information disclosure effectiveness and on compliance costs and crosses boundaries between ARs.
<b>Regulatory information returns</b>	These issues are closely linked to supervision and therefore better included in a wider consideration of supervision rather than on a standalone basis.

	However, there is little evidence on the cost of providing these returns which could favour its inclusion, but an example of approaches on compliance costs would be set out if information disclosure is assessed.
<b>Supervision</b>	BSB supervisory process is currently under development and more detailed work to ensure proportionality should either happen now to benefit its development or should be delayed to switch the focus on assessment. SRA approach is already underway which could favour delaying assessment, although there is little evidence available on the cost impacts on firms.
<b>Insurance requirements</b>	Most ARs have not conducted research although the SRA requirements have already been subject to detailed review (subsequent decisions could still be included in the main phase). Feasibility would be dependent on ensuring engagement with Bar Mutual and other brokers/insurers acting in these markets (e.g. in relation to the CLC policy). Differences between regulators may restrict business models across legal services
<b>Separate client accounts</b>	Current economic conditions may have increased the importance of SRA rules and their complexity although this is mainly a compliance issue rather than bringing competitive effects. This, as well as comparisons with other sectors and countries, could be considered now, although BARCO has only just been developed and therefore some time would need to elapse before it is assessed. Data difficulties would also need to be resolved.
<b>Compensation funds</b>	SRA Compensation Fund review already in progress, but ensure that issues identified are considered in the course of the review and consider position for other ARs.
<b>Enforcement mechanisms</b>	Few firms are directly affected by it and the tribunals are independent of regulators which may have implications for how any change could be brought about. However, there may be benefits from its inclusion on the grounds of the spread of different options and the detriment from delays.

Having set out the summary factors in the table above, Figure 2 below provides a graphical representation of the order of priorities of the different issues.

**Figure 2 Summary of priorities**

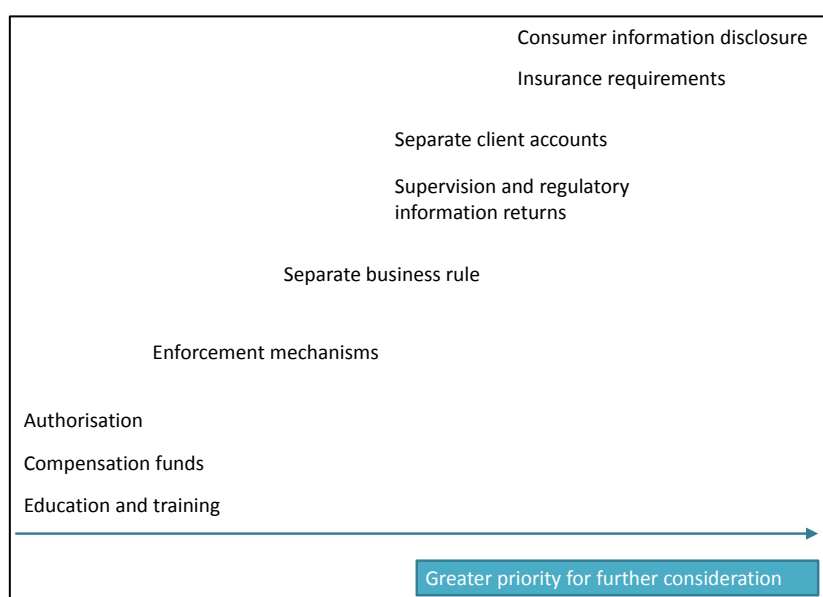


Figure 2 does not imply that the areas of regulation which are to the left of the picture are necessarily proportionate or indeed that they require no further investigation but rather that those issues to the right of the picture are the ones likely to be most fruitful for evidence gathering and analysis at this time.<sup>80</sup>

#### *Next steps*

The most appropriate next step is for the LSB to discuss with the ARs whether, and to what extent, they already have evidence which addresses many of the issues highlighted in the report. Some of this may be readily available, while other issues may require interrogation of existing data in a new way and examination of that data in the light of concerns regarding proportionality.

In addition, each of the sections in Chapter 2 has highlighted some of the ideal evidence that would be needed in order to be able to assess whether the particular form of regulation is in fact proportionate to the underlying problems. Typically these have included a combination of data that can be gathered along with where a more qualitative understanding of the issues may be required.

In some of these cases the concerns regarding disproportionality are well-understood and ARs may already be taking steps to consider these (including through the LETR, Compensation Fund review and the fact that the SRA has committed to improving the authorisation process).

In other areas, evidence gathering will require primary research to be conducted beyond that which is already available from ARs and other sources. The priority as to where to focus such primary research should result from the priorities set out in Figure 2 adjusted in the light of any additional evidence gathered from ARs.

Given the breadth of issues it would also be appropriate for the LSB to work with the ARs to identify which areas of further investigation would best be led by individual ARs and which areas should be taken forward by the LSB.

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<sup>80</sup> Note that the priority is determined from left to right; the differences in height are for presentational purposes only.