

## **Understanding barriers to entry, exit and merger**

### **Summary and main conclusions**

Entry, exit and firm restructuring are important aspects of the ability of any market to respond and adapt to changing circumstances. The capacity to respond and adapt relatively quickly – often referred to as flexibility – is important for the effective performance of a market, particularly in periods of substantial change.

The study is concerned chiefly with barriers to entry, exit and ‘mobility’ (which includes business restructuring such as a merger) that may be caused or exacerbated by regulatory requirements, with particular reference to the barriers facing small solicitors’ practices. The approach adopted was based on a combination of desk research and 34 interviews with a range of people who are knowledgeable about the relevant market and market segments (including regulators, professional bodies, insurers, and advisors/consultants to law firms, as well as a number of regulated firms themselves). This exercise was supplemented, largely for purposes of cross-checking, by information drawn from three small scale surveys of legal practices, which produced 101 responses in total.

Statistics on entry, exit and structural change in the market indicate substantial amounts of activity. The entry and exit rates over the past two or three years appear to have been around 10%, with most of the exit occurring via amalgamation rather than by simple closure. That is, for every ten existing practices, about one practice a year disappears and one appears. These are a little below average entry and exit rates across all UK businesses, but not sufficiently different as to suggest any major, underlying problems.

In terms of business structure, there has been a marked shift away from sole proprietorships and traditional partnerships towards limited company status and LLP status. The number of limited companies has grown very quickly.

At a broad level, therefore, the market has shown itself capable of significant change.

We have, however, found a number of ways in which regulation can be said to be impeding flexibility and innovation in business structures and business practices. The problems lie not so much in individual regulatory requirements – although there are one or two of those that are particularly problematic – but rather in the way that sets of requirements are formulated and enforced. Further, the impediments are more pronounced for some specific types of practice such as small practices and non-traditional business models (including, but not limited to, ABSs).

In relation to specific issues, insurance was the major, single regulatory requirement that gave rise to difficulties for firms at each of the stages of entry (because authorisation is contingent on securing insurance with the coverage specified), merger (because a successor practice may have to fund protection against the unknown liabilities arising from the previous conduct of an acquired firm) and exit (because of run-off insurance requirements on closure or, in cases of exit by merger, because of the aforementioned succession issues).

We conclude that current insurance requirements may be disproportionate in relation to the LSA objectives, particularly given that (a) consumers rely on a range of protections, not just insurance, and (b) insurance is not motivated by consumer protection alone (it also protects solicitors from the potentially damaging conduct of colleagues in the same firm), (c) the requirements may force exit of firms that could potentially have a viable future, thus reducing supply in the market, to the potential detriment of consumers. A particular problem arises from the limited grace period of only 30 days during which a firm is permitted to trade without insurance cover, a period which appears generally insufficient to enable it most efficiently and effectively to find alternative cover and to take all necessary actions to try to rectify the relevant problems.

We, therefore, suggest consideration be given to relaxing existing insurance requirements, which, at a minimum, might give practices a longer time (of say 3 months) to re-adjust their business strategies in the event of a failure to secure insurance cover.

The bigger issues, however, lie in three aspects of the general regulatory approach, as follows:

First, it is difficult to understand what is being achieved by regulatory activity focused on *ex ante* assessment the business models, structures, governance and finances of thousands of very small *entities*, rather than on the conduct of individual professionals or on more *ex post* approaches based on harm done, as in competition law. There seems to be a lot of regulatory activity (including compliance activity) generated around *ex ante* supervision of entities, particularly in relation to business risk assessment, but it is not clear that there are clear, demonstrable benefits. On the other side of the equation, there are obvious costs: both SRA resources and compliance resources have to be paid for, solicitors' costs are higher as a result, and it is likely that at least some of those increased costs get passed through to consumers. There is also the issue of the competence of any regulator to undertake this kind of detailed assessment of the commercial activities of large numbers of firms.

Perhaps more significantly, risk-based regulation focused on business matters tends to mean that costs are raised most for business models that are the most innovative and unfamiliar: it is these that attract regulatory attention. The extra costs caused include higher costs of entry and of business restructuring. One consequence is encouragement of firms to converge on the traditional ways of doing things, and to shy away from doing things differently. We are therefore of the view that the approach serves to chill experimentation and innovation which, as we understand it, is not the kind of outcome that the LSA was seeking to achieve.

Second, the risk-based, outcomes-focused approach that has been adopted appears not to be well-targeted on, or closely linked to, the LSA objectives. In particular, we find a lack of close connection between the SRA Handbook requirements and the objectives of (a) protecting and promoting the interests of consumers and (b) promoting competition. There is no strict hierarchy in the LSA objectives, but the relative lack of connection to two of eight objectives raises substantive issues. Most strikingly, whilst the specified mandatory outcomes explicitly address issues concerning the quality of service provided to clients, there is an absence of any clear recognition of the fact that consumer interests are ill-served if, no matter how good the services are, they represent poor value for money. In relation to entry, mobility and exit barriers, the major concern is again the possibility of a resulting bias against innovative business strategies. We suggest that the mandatory outcomes relating to clients' interests be revisited, with a view to explicitly recognising that poor value for money is a form of consumer harm (the client is worse off as a result of the transaction).

Third, the regulatory requirements appear to involve a great deal of unnecessary duplication of effort, which again has the effects of raising solicitors' costs, including entry, merger and closure costs. A system that, in effect, leaves a large amount of work to be done by each of thousands of small businesses to work out what it is they have to do to comply with what appears to be a complex and not self-evidently coherent set of regulatory requirements, will tend to raise the costs of doing business. More significantly, it has the potential to divert non trivial amounts of the key resources of small practices (the time, attention and cognitive effort of the proprietors or partners) from other matters, such as the practice of law and the training of the next generation of lawyers. On the enforcement side, the SRA's assessment of business and financial risks seems to us to duplicate large parts of the assessment activities of insurers and providers of capital, including, but not limited to, banks. We suggest there is scope for simplification, involving the SRA reducing its own activities in these areas, and relying more on the commercial organisations that do the job in other sectors, including in other professional services.