Legal Services Act: New forms of practice and regulation

Consultation paper 16

Better regulation: A new approach to regulating legal services firms and solicitors

Contents

Introduction

Why a new approach?

1. This paper sets out the Solicitors Regulation Authority's evolving new approach to regulation, and in particular how the shift towards regulating legal firms will affect the way in which we regulate. There are a number of factors driving this new approach:

    - The SRA inherited an approach to regulation which had been predominantly reactive, generally secretive, and concerned with the regulation of individuals in small practices;

    - The SRA's strategy, published in 2006, signalled a shift to more explicit risk-based regulation in the public interest;

    - The principles of better regulation will soon to apply to all legal regulators as a statutory objective;

    - We also need to build a more flexible form of regulation fit not only for the current wide range of firms but also one that can be appropriately adapted to new forms of practice, both legal disciplinary practices (LDPs) and alternative business structures (ABSs) in future.

    - New statutory powers give the SRA more flexibility than we had before and require "firm based" regulation as well as the more traditional regulation of individual solicitors etc.

2. Much of our recent work has necessarily concentrated on the changes in rules, regulations and procedures to enable new forms of practice from March 2009. This has involved the concentration on what looks little more than new bureaucratic regulatory processes. Those processes are necessary, but are only part of the changes required to deliver the new approach.

The new approach

3. We are setting a new vision of law firms regulated by the SRA. We want to concentrate our resources on dealing with serious risk. We want to encourage law firms to tackle risk themselves wherever possible, reducing the overall regulatory burden and allowing us to concentrate upon those who can't, or won't, put things right. To do that, we need to build a new relationship between the SRA, as regulator, and the firms we regulate.

4. We recognise that the vast majority of firms wish to act ethically and to be compliant with the relevant rules and regulations. Firms who respond positively to the new relationship can expect lighter regulation. (Those who don't, and those who do not recognise that this new relationship needs to be built on some degree of mutual trust, will be dealt with severely if something goes wrong as a result.) The development of new supervisory visits for larger corporate firms is part of our shift in emphasis. Regulatory settlement agreements, which have been used successfully to deliver appropriate but

proportionate regulatory action where firms are willing to take responsibility for past breaches, are also part of the shift in emphasis.

5. This paper largely concentrates on how the SRA intends to adapt its policies relating to enforcement and disciplinary action in the light of new statutory powers relating to firms, but these issues should be seen as a key part of developing this broader new approach.

Impact on disciplinary and enforcement action

6. Historically, the SRA, like other professional bodies, has viewed conduct and regulatory obligations as an individual matter. The individual takes responsibility for their own actions or omissions, and, therefore, nearly all disciplinary and enforcement action has been applied to individuals.

7. However, the position is changing. Although many firms still operate as partnerships, there is an increasing tendency for firms to practise through an incorporated company, either an LLP or a limited liability company. This has been reflected in the way we now apply some of our regulatory powers; but, in general, even where the firm has incorporated, we have continued to look to individuals to be accountable for both breaches of rules and for professional misconduct more generally.

8. The principle of firm-based regulation has been recognised as appropriate by Parliament. The Legal Services Act 2007 will require "entities" providing reserved legal services to be authorised and regulated as well as the individuals providing such services within the entity. In addition, the Legal Services Act, through amendments to the SRA's own statutory powers, provides a system of firm-based regulation for the SRA.

9. The position in respect of statutory powers will change considerably in 2009, when the amendments to our statutory powers come into force. At that time:

(i) rules will, in effect, apply directly to:

- individual solicitors, RELs (including sole practitioners) and RFLs
- all recognised bodies (i.e. all firms except sole practitioners);
- all "managers" of recognised bodies (whether solicitors or not); and
- all employees of firms (including those of sole practitioners).

(ii) the SRA will have the power to impose conditions on:

- individual solicitors, RELs and RFLs;
- recognised bodies; and
- recognised sole practitioners.

(iii) the SRA will have the statutory power to rebuke and / or fine and to publish such a decision in relation to:

- individual solicitors, RELs (including sole practitioners) and RFLs;
- all managers of recognised bodies (whether solicitors or not);
- all employees of recognised bodies and sole practitioners; and
- recognised bodies.

(iv) the Solicitors Disciplinary Tribunal (SDT) will also have additional powers, and will be able to:

- fine all or any managers/employees of recognised bodies;
- fine employees of recognised bodies and sole practitioners;
- fine recognised bodies and sole practitioners; and
- refer particular managers or employees to their own professional bodies.

10. In addition, the SDT's power to fine, previously limited to £5,000 per finding, becomes unlimited, which will be significant when determining who and how much to fine.

11. The SRA's key objectives already reflect the move to firm-based regulation. For example, there is the objective "to tackle unacceptable professional or organisational performance misconduct and dishonesty by firm, fair and timely regulatory and disciplinary action". The SRA now needs to change its policies in the light of the new statutory powers. In future, disciplinary decisions can be made against firms as well as individuals. The SRA Board believes that there should be a significant shift in emphasis to taking action against firms, where appropriate, rather than individuals, although it will still be necessary to take action relating to individuals in certain circumstances.

The key benefits of the shift in emphasis

12. Looking ahead, the Legal Services Act requires both the Legal Services Board and approved regulators to have regard to the principles under which regulatory activity should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed. Codes of practice issued by the Better Regulation Executive recognise in particular that investigation, enforcement and disciplinary activities are costly, and regulators are encouraged to invest in prevention rather than a costly cure.

13. In many cases, enforcement and disciplinary action are not required as the intervention of the regulator can often encourage firms who have been in breach to put things right for the future. Disciplinary processes therefore should only be used when required. The focus of regulation must be on public protection, and disciplinary action is sometimes required to maintain public

confidence, to encourage better behaviour in the rest of the regulated community, and to operate as a credible deterrent. Disciplinary action need not always follow an adversarial process and can now be delivered through regulatory settlement agreements

14. Risk assessment is key to these issues, and the SRA has already developed a new risk assessment system to ensure that compliance and inspection activity is appropriately targeted. (This has been developed against a background in which the SRA has very little information about the firms it regulates. The new statutory powers on firm-based regulation will improve the SRA's ability to seek information from firms and use that in risk assessment for the future.) The SRA Board believes that better regulation indicates that allegations, complaints and information giving rise to concern should first be addressed as the firm's responsibility unless the allegation or complaint is in a particular category which makes it necessary to deal with it as an individual issue. Annex 1 sets out some advantages or disadvantages of moving towards a "firm first" approach.

15. The groundwork for this firm-based approach has already been laid in rule 5 of the current Code of Conduct dealing with business management. That rule requires all principals in a firm to make arrangements for the effective management of the firm as a whole; to provide for compliance by both the firm and individuals with key regulatory requirements, and to provide systems for appropriate supervision of and compliance with a number of regulatory issues including conflict of interest, client care, undertakings, etc.

16. Allegations or information that point to dishonesty or fraud which may potentially need to be dealt with by the Solicitors Disciplinary Tribunal are likely to require investigation and action against individuals. However, in those cases, it will also be important to assess the relevant firm's responsibility to have in place systems which seek to minimise the risk of dishonesty or fraud in a firm. Annex 2 sets out the criteria that we believe indicate that an individual should be investigated. It also contains a suggested "decision tree" showing how the new policy will apply in practice.

Question 1

What are your views on the suggested criteria and decision tree?

A new relationship?

17. Self-regulation systems tend not to prescribe the relationship between the members of the professional body and the body itself. The current Code of Conduct, in rule 20, reflects only the aspects of the relationship seen as necessary in the context of self regulation.

18. Rule 20.03 provides a duty to cooperate with the SRA and LCS, in an open, prompt and cooperative way. Rule 20.04 provides a duty to report serious misconduct by other solicitors and firms or your own employees to the SRA—again based on the fact that a profession has an ethical duty to uphold high standards.

19. If firms are to be expected to take on a greater degree of responsibility for regulating the quality and conduct of their employees, this should be reflected in the Code. We believe that a new core duty may be required, along the lines of the FSA principle:

"A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice."

20. This goes beyond the current requirements in rule 20 but would be the basis of a relationship which recognises that the public interest is best served by an open relationship which encourages firms to demonstrate to the regulator a willingness to disclose problems and take action to put things rights.

21. It has been suggested that in some situations, perhaps where the allegations relate to particular types of breach of rules, the SRA could go further and, in effect, leave firms to take action to identify and put right minor breaches themselves. The SRA Board considers this may be something for future development. But such a proposal would certainly require an amendment to the core duties as suggested in paragraph 19 above, and may rely on there being compulsory roles in all firms as will be required under the Legal Services Act 2007 for ABSs in future (e.g. the role of a "Head of Legal Practice" and "Head of Finance and Administration").

Question 2

What are your views on the adoption of a new core duty defining a firm's relationship with the regulator?

Practical issues – disciplinary history

22. An important consequential decision is whether a decision or finding against a firm should form part of the record of the managers of the firm—albeit simply as a record that the individual was the manager of a firm which itself was found to be in breach.

23. Clearly, if a decision is made against a firm and also against an individual, then any decision against an individual will be part of their individual record.

24. The SRA believes that it is in the public interest to have a system which can demonstrate where individuals have worked in the past and whether they have worked in a firm that has been disciplined. This is particularly important in an LDP environment or, in future, for ABS. Not to have such a record would allow those included in firms with a poor disciplinary history to set up "phoenix" firms.

Question 3

Where a disciplinary penalty has been applied to a firm, do you agree that it is important for the record to show those who were the managers in a firm that has been disciplined?

Conclusion

25. We would welcome comments on the new approach described in the introduction to this paper.

26. Also, in the context of the SRA using new powers to regulate, and so investigate and take disciplinary action against a firm, we would welcome comments that directly address the questions set out below.

Summary of consultation questions

Question 1

What are your views on the suggested criteria and decision tree?

Question 2

What are your views on the adoption of a new core duty defining a firm's relationship with the regulator?

Question 3

Where a disciplinary penalty has been applied to a firm, do you agree that it is important for the record to show those who were the managers in a firm that has been disciplined?

How to respond

For information on how to respond, please visit our website.

- Go to www.consultations.sra.org.uk.
- Select **Better regulation: A new approach to regulating legal services firms and solicitors**.
- Click **How to respond**.

Submission deadline

The deadline for submission of responses is **31 March 2009**.

Annex 1

Advantages of taking regulatory/disciplinary action against a firm

Broadly, there could be said to be the following advantages:

- such a policy would be in line with the SRA's strategic objectives and better regulation principles;
- it is more "cost effective"—improving regulatory compliance in firms provides a positive outcome for all clients and prospective clients;
- it enables focus on the real issue (e.g. if it is a case of poor accounts rule compliance, it should be irrelevant that an individual solicitor has an unblemished record/has suffered personal recent loss etc.);
- it avoids the need to apportion responsibility amongst partners in order to ensure that the proceedings are brought against the right individuals, which can take more investigation resource and so more time;
- it is arguably less emotive, so leading to a less emotional response from the affected firm as it not a question of "personal or moral" culpability;
- it encourages collective responsibility.

Advantages of taking regulatory action against individuals

These could be:

- there is much to be said for individuals taking personal responsibility for their own action and that of their firms, and that is a strong tradition in professions;
- a policy of routinely regarding regulatory breaches as the firm's responsibility rather than that of an individual or individuals would run counter to the tradition of regulation in the solicitor's profession and may mean that such breaches were regarded as not so serious; rather than promoting collective responsibility, it may promote the abdication of responsibility;
- firms can come and go; concentrating action against the firm may lead to "phoenix" firms and an inability by the SRA to track "risk" through individual responsibility for non-compliance;
- some "managers" in firms who have not been involved in whatever has gone wrong may, in fact, object to the firm as a whole being held liable rather than the individuals who are responsible.

Annex 2

Criteria to determine the focus of an investigation:

The primary responsibility for ensuring compliance with a firm's regulatory obligations rests with the firm itself. However, there may be instances in which there is evidence of personal culpability and where, in consequence, the SRA may wish to investigate the individual as well as, or instead of, the firm. The presence of any the following circumstances might suggest that the SRA should investigate the individual:

- fraud—including mortgage and property fraud, money laundering and high yield investment fraud
- dishonesty/deception—deliberate and intentional behaviours
- misleading—intentionally misleading the courts, third parties and clients
- discrimination
- abuse of a position of authority or trust for example when acting as Receiver or Attorney
- a report about an individual under Rule 20.04
- serious—conduct which was systematic, deliberate or pre-meditated with potential for significant adverse impact or involving a vulnerable person
- serial—repeated or systematic conduct having regard to previous history
- criminal convictions
- personal responsibility at law
- failure to comply with personal regulatory requirements—including practising uncertificated, breach of PC conditions, breach of section 43 order
- Solicitors Act offences—including holding out, reserved work or offences under sections 41 and 44
- conduct outside practice which warrants investigation, for example, dishonesty or serious misconduct
- SRA policy (if relevant)
- public interest—raises issues about the conduct of an individual which it would be in the public interest to investigate or issues of particular sensitivity or importance

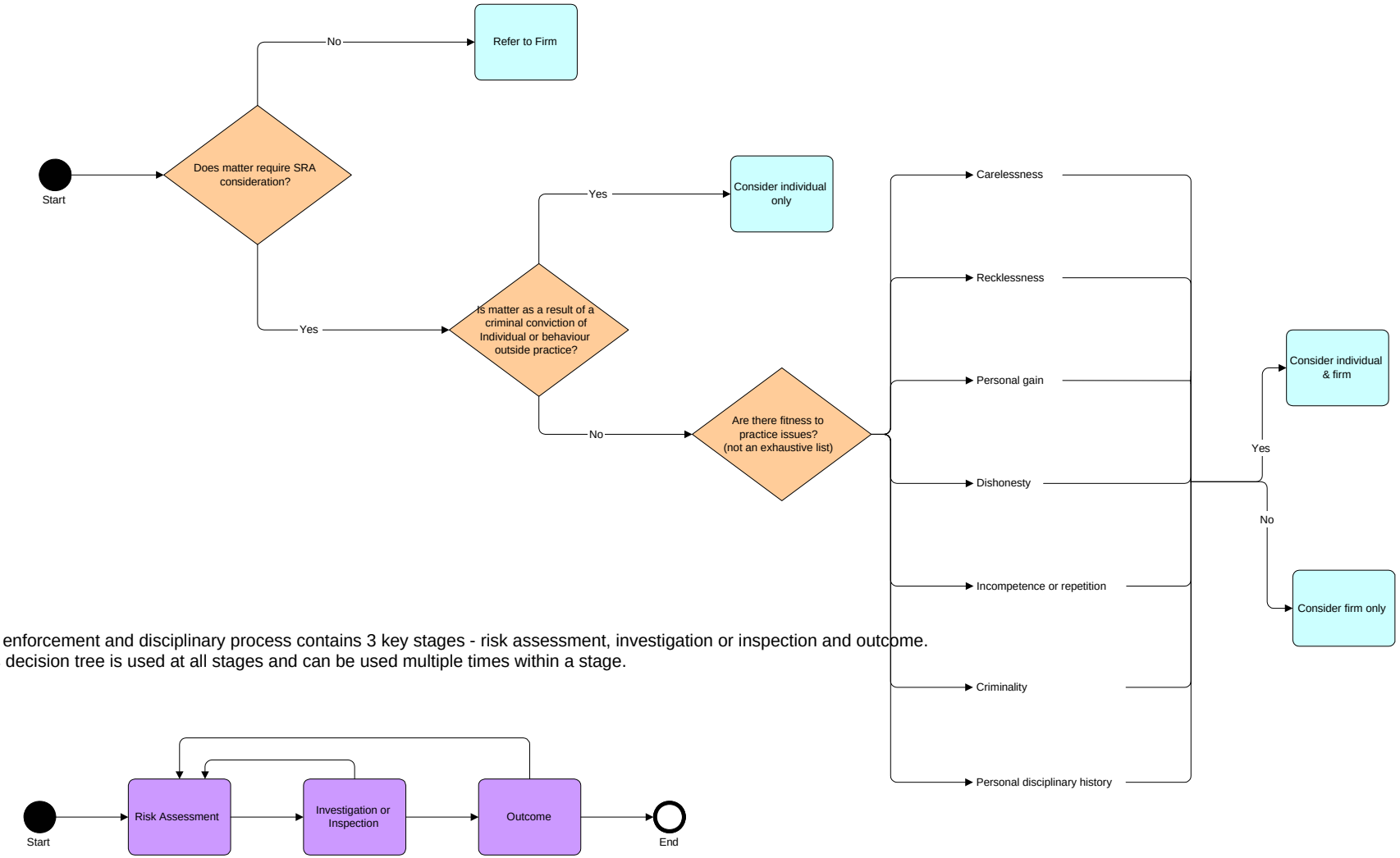
When deciding whether to investigate the individual, the SRA will need to consider not only the type of matter but also the personal behaviour of any individual involved and in particular whether there is evidence of any of the following with regard to the individual which may indicate some direct personal responsibility:

- recklessness
- personal motive such as gain for self or family members/friends
- criminality
- repetitive behaviour
- adverse personal regulatory history relevant to the allegation

Although in almost all matters the individual investigation will be in conjunction with an investigation of the firm, there may be some instances where only the individual will be investigated and the firm will not be part of any investigation. Such instances will be infrequent but may include, for example, personal criminal behaviour outside of practice, such as drink driving.

The decision tree below sets out the factors to be considered when considering the most appropriate focus for any investigation and when, although the decision as to who to investigate can be reconsidered at any time during an investigation.

Firm/individual focus of enforcement and disciplinary action – decision tree



The enforcement and disciplinary process contains 3 key stages - risk assessment, investigation or inspection and outcome.
This decision tree is used at all stages and can be used multiple times within a stage.