Regulating alternative business structures

Legal Services Act: New forms of practice and regulation

Consultation paper 18

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Foreword

Consumers have a right to high quality, good-value, accessible legal services. Regulators have a duty to enable those services. This discussion paper sets out the Solicitors Regulation Authority (SRA)'s proposals to deliver changes in the provision of legal services in the interests of consumers, and invites a wide debate. This paper should be seen as complementary to the Legal Services Board's discussion document "Wider Access, Better Value, Strong Protection", which was published as we were finalising this.[1]

The Legal Services 2007 Act allows legal services regulators to dismantle the restrictive practices imposed by the regulatory regime under which law firms could only be owned and run by lawyers. On 31 March this year, we removed tight restrictions on who can own and manage solicitors firms. Legal disciplinary practices (LDPs) of mixed kinds of lawyers and with up to 25 per cent non-lawyer managers are now permitted. At the same time, we modernised our powers, to allow us to regulate firms as well as individuals. Those changes are stepping stones to a much greater change in the legal services market—the delivery of legal services through alternative business structures (ABSs). It is that change which has the potential to have a major impact upon consumers' experience of legal services, stimulating competition, encouraging innovation, while safeguarding standards. We share the Legal Services Board's objective to deliver that change in 2011.

The approach set out in this paper starts from some assumptions:

- The prompt liberalisation of the legal services, as set out in the Legal Services Act, is a given, and to be welcomed in the public interest.
- The debate should concentrate upon the desired outcomes for consumers and how regulation can best assure those outcomes.
- There should be no assumption that traditional business structures are inherently safe and new structures inherently risky.

While alternative business structures will present some new regulatory complications, it is our view that they will not fundamentally alter the regulatory challenge. Regulators which, like the SRA, have traditionally focused upon the regulation of individuals and smaller organisations need to ensure that they can regulate a wide variety of organisations providing legal services, from sole practitioners to international corporates. The SRA is already engaged in a programme of reform to focus our regulation more effectively upon risk, to remove unnecessary barriers, to concentrate upon firms rather than exclusively on individuals, to engage with and regulate legal firms more effectively and intelligently, and to ensure that we can act promptly and effectively when the public interest is threatened. We acknowledge that the introduction of ABSs will be seen by some existing firms as presenting a challenge or even a threat, though others will welcome the opportunities they offer.

[1] See www.legalservicesboard.org.uk/news_publications/press_releases/2009/06_2009.htm.

We look forward to discussing these proposals with all those who have an interest in legal services.

Peter J Williamson
Chair

Antony Townsend
Chief Executive

1. A vision for the regulation of legal services

1.1 In January 2009, we published a consultation "Better Regulation: A new approach to regulating legal services firms and solicitors".[2] That paper set out the SRA's new approach to regulation and, in particular, how the shift towards regulating legal firms will affect the way in which we regulate. It said:

The factors driving this new approach are as follows:

- ***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[3], published in 2006, signalled a shift to more explicit risk-based regulation in the public interest.***
- ***The principles of better regulation will soon 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.***

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

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.

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

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[2] See www.sra.org.uk/sra/consultations/1802.article.
[3] See www.sra.org.uk/strategy.

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.

1.2 Our view is that that approach is the right one for all forms of legal services delivery, including ABSs. We now need a step change in the way we regulate. We are looking closely at the Financial Services Authority's new focus on outcome-based regulation and their review of their supervisory regime. We need to use the advent of ABSs to review our risk analysis and regulate the firms we currently regulate according to that review—and then translate that experience into an effective system of regulating ABSs.

2. Starting principles for the regulation of ABSs

2.1 We share the vision of the Legal Services Board for the future of legal services based on the public policy set out in the Act. Greater competition in service delivery and the delivery of innovative ways of meeting consumer demand balanced by consumer safeguards, where necessary, are a key part of the reforms.

2.2 In November 2007[4], we adopted the following strategic principles for the development of legal disciplinary practices (introduced on 31 March 2009), and which we consider equally relevant as we now develop a framework for ABSs.

Strategic principles

"The SRA's strategy reflects the regulatory objectives (of the Legal Services Act) and principles of good regulation. It contains the following key objectives that are relevant to the design of this new framework for practice: 'to set standards for organisations offering legal services; to promote choice, innovation and accessibility in the provision of legal services through different types of business structure.' Relevant strategic outcomes include: 'ensuring that there are no unnecessary barriers to competition, and that the requirements on practitioners and organisations, and any restrictions on the way in which legal services are provided are only those necessary and proportionate to secure the regulatory objectives.'

"Key to the SRA's desire to become a more efficient and effective regulator is developing its ability to target regulatory action according to risk. Firm-based regulation provides the opportunity for us to gain relevant information about the firms that we regulate and so enables us to assess risk and target resources accordingly."

2.3 We also adopted some design principles which were unchallenged through the consultation period which we used to build the regulatory system for legal disciplinary practices.

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[4] See www.sra.org.uk/sra/consultations/341.article.

2.4 The first principle was as follows:

"We will adapt our regulations to enable the new forms of practice provided for in legislation, and will only impose restrictions, over and above those provided for in the Act, when necessary in the consumer and public interest."

2.5 Our starting principle for the design of the ABS system is the same. The Act lays a foundation for the creation of a regulatory framework for ABSs which is capable of reducing or managing the risks identified by the Clementi report5 and in debates in Parliament. It would be possible for the SRA to add its own restrictions. We start with the proposition that our proposed regulatory framework will not seek to add unnecessarily, if at all, to the minimum conditions required in the Act.

2.6 There have been suggestions, both in the Clementi report and afterwards, that a step-by-step approach—"learning to walk before you can run"—is the right way forward. Many may think that is all the more important in the current economic climate and in the light of the apparent deficiencies in the regulation of the financial markets. However, we do not think that a gradual, step-by-step approach, beyond the first step we have already taken with LDPs, is necessary or appropriate.

2.7 We believe that we should start with a system that delivers the framework provided for in the Act and one in which the regulation is the minimum required to mitigate the risks. Certain risks can be mitigated through the entry requirements, and later in this paper we set out the minimum requirements in the Act. However, entry requirements are not the only way of mitigating risk, and a concentration upon entry requirements assumes that the principal risk to consumers and the public interest arises from, and will be mitigated by, controls upon structure.

2.8 In our view, the principal risks to consumers from ABSs are not intrinsically different from the risks from traditional law firms—a failure to put the interests of consumers first, conflicts of interest, dishonesty, and incompetence. While entry requirements play a part in reducing that risk, what is required is a mixture of a commitment to high standards in legal services providers, intelligent supervision by the regulator, prompt effective intervention and sanctions where required, and consumer education.

2.9 ABSs will require a shift from the historical focus on individuals with a reactive form of regulation, to a regulatory body which is proactive, risk-based, preventative and focused on entities. We have started that work in relation to traditional law firms, and we intend to accelerate that to provide for ABSs.

2.10 The other key principle which we propose is that the public are entitled to the same ethical standards and minimum standards of service from all providers of legal services. A consumer buying a conveyancing service from a high street store should receive the same ethical standards, consumer and financial protections and minimum service levels as they would from a traditional solicitors' firm. The key driver for the reforms in the Legal Services

[5] See www.legal-services-review.org.uk/content/report/.

Act was the removal of unnecessary restrictions on the types of business that could provide legal services. There was little criticism of the consumer protections provided by the existing regulatory frameworks, apart from the lack of independence from representational interests in both consumer complaints handling and regulation. We see no public policy wish to reduce or remove the consumer protections provided at the moment.

2.11 In summary, we consider that the approach to regulating ABSs should be

- the application of the same ethical standards, standards of service and consumer financial protections irrespective of business model;
- the mitigation of risk through appropriate risk-based entry requirements, the further development of supervisory arrangements for organisations providing legal services, and prompt and effective sanctions for non-compliance;
- the avoidance of detailed rules prescribing or proscribing particular business models.

Discussion points

i. Do you agree with our starting proposition set out in paragraph 2.5?

ii. If not, please explain what additional restrictions you believe may be necessary to address what risks.

iii. Do you agree that we should try to provide a regulatory framework for ABSs as soon as possible? Please give reasons for your answer.

iv. Do you agree with the principle that the ABS regime should provide to the public the same consumer protections provided by the current regulatory framework?

v. If you disagree, please give reasons explaining which consumer protections you consider necessary for ABSs.

3. What is an ABS?

3.1 Very broadly, ABSs will enable lawyers and non-lawyers to share the management and control of a business which provides reserved legal services to the public. ABSs will allow external investment and ownership of law firms.

3.2 The minimum requirements for an ABS are that

- it must have at least one “manager” who is authorised to provide the reserved legal activity delivered by the ABS, and
- it must have at least one non-lawyer “manager” or owner.

Note that the word “manager” in the Legal Services Act 2007 refers to a partner in a partnership, a director in a company or a member in an LLP and this paper uses the same definition.

3.3 The potential models for different ABSs are therefore very wide-ranging. When the ABS provisions in the Act are brought into force, it appears that an existing legal disciplinary practice with even one non-lawyer manager will need to be licensed as an ABS. At the other end of the scale, major commercial organisations could buy a law firm or set up a subsidiary to provide reserved legal activities. There are many models in between: private equity will be able to invest in law firms; law firms might float on the stock market; lawyers and other professionals could come together to provide a range of services through one business. Appendix A sets out some, by no means exhaustive, examples—with a brief commentary on the regulatory implications for each.

3.4 There are probably three broad types of model. Firstly, firms which are basically like traditional law firms or legal disciplinary practices, but with the involvement of one or more individual non-lawyer managers (which may not be limited, as now, to 25 per cent ownership and control), without external ownership, and providing solicitor-type services only.

3.5 The second model would include complete or partial external ownership with the legal services being operated through a ring-fenced entity. If a high street store were to set up a legal services division, it is likely to set up a separate subsidiary, ring fenced from the rest of its activities, so that only the ring-fenced company will be regulated as an ABS.

3.6 The third model would involve combinations of different services within one entity, the multidisciplinary practice model.

3.7 The current basic framework of regulation, adapted to focus upon outcomes and intelligent supervision, can relatively easily be applied to models one and two, with some additional provisions to deal with risks associated with external ownership. The third model presents more of a regulatory challenge, although not necessarily additional risk, in that it would not be appropriate, for example, to apply rules relevant to legal work to a completely different service.

3.8 Our proposition is that it is neither helpful nor necessary to build a regulatory framework around particular models for ABS. A generic framework should allow for the widest range of models, with no restrictions on any particular class of person or organisation who can own an ABS, and without restricting the firm to providing only solicitor-type services. However, we would be interested in views as to whether any particular model should be prohibited from the outset.

Discussion points

vi. Do you think that there are other broad models than the three set out here?

vii. Do you think there are other examples of models to be added to those in Appendix A?

viii. Do you agree that the regulatory regime should focus upon outcomes and supervision, rather than attempting to restrict business models?

4. What is the SRA's broad approach to the regulation of ABSs?

4.1 We think the quickest and most effective way for the SRA to create a new licensing scheme for ABSs is the approach set out in paragraph 2.11 above, applying existing ethical standards and consumer protections while introducing some new entry requirements and a developed, risk-based, supervisory, outcomes-based regime. We have reached that conclusion as a result of the principles we set out in Part 2 above. We do not believe that the ABS regime needs to start from a blank piece of paper in relation to the key consumer protections delivered by the current regulatory framework. The regulatory objectives themselves support the maintenance through the ABS regime of protecting and promoting the public interest; protecting and promoting the interests of consumers; encouraging a strong, diverse and effective legal profession and promoting and maintaining adherence to the professional principles.

4.2 The regulatory framework which the SRA inherited was broadly a reactive form of regulation dealing with problems after they had occurred on a case–by-case basis. That is not risk-based regulation as required by the Act for Approved Regulators and Licensing Authorities alike. On 31 March 2009, our statutory powers were significantly improved to enable us to roll out firm-based regulation and so improve our ability to regulate according to risk—and to have the information to be more proactive and preventative. Our developing form of supervisory regulation will seek to support and encourage firms to achieve compliance and not see punishing non-compliance as the only outcome. We strongly believe that this approach will be fit for the regulation of ABSs.

4.3 Our current regulatory framework has the following core requirements, which we would propose to apply broadly to ABSs. Using existing administrative procedures where they are "fit for purpose" for ABSs will allow us to minimise the cost, and enable us to deliver the basic regulatory procedures within the timescale we have set.

- All firms (whether partnerships, LLPs or companies) must be recognised (as a recognised body) prior to providing any legal services to the public. Recognition can be granted subject to conditions and can be revoked. There is an annual renewal process.

- All lawyer managers, through being authorised to practise by their individual approved regulator, are prima facie deemed to be fit and proper to manage or to own a law firm.

- All non-lawyer managers (whether or not also shareholders) must be individually approved as "fit and proper".

- The Code of Conduct and other relevant rules and regulations (Accounts Rules, Indemnity Rules, Compensation Fund Rules) are

directly applied to the firm and to all managers and employees whether lawyers or not.

- We have a wide range of statutory investigation, intervention, enforcement and disciplinary powers which can be applied to firms, managers and employees and to all individual solicitors etc authorised by the SRA. These include the removal of recognition of a firm, the striking off of individuals, unlimited fines, and other sanctions. We consider that these will be appropriate for ABSs

- The regulatory framework applies to all "solicitor" services provided by the firm and, therefore, to both reserved and unreserved legal services, and to other business and personal advisory services of the type provided by solicitors.

4.4 Although applying these principles to firms with external owners will add some complexity to our processes, we do not consider that a fundamentally different approach is required. Applying the above framework to the regulation of ABSs would meet most of the requirements of section 83 of the Legal Services Act.

4.5 Clearly, a number of issues arise as to how particular aspects could or should be adapted to ABSs and, in particular, as to those external owners (individuals or bodies) who are not also managers and who, under the Act, will have to comply with a "fit and proper" test. Our starting position would be to adapt our current "fit and proper test" (which deals with probity and financial soundness on an exception basis) to those external owners which the Act requires to be subject to the test. Additional provisions will need to deal with corporate ownership, for example to deal with the model where an ABS is a subsidiary of, say, a plc. Other regulators already have tests which can be adapted.

4.6 Further thought will be needed as to how to adapt the framework to regulate the third broad model referred to in Part 3 above—the multidisciplinary model, where the delivery of legal services is not ring-fenced from other models. This will require our regulation to be adapted to a "services" model rather than an "entity" model in some areas. There are existing models for this within other regulatory systems from which we can learn.

Discussion points

ix. Does this seem the right approach to the prompt introduction of ABSs?

5. What issues need further consideration?

5.1 There are clearly a number of requirements of the Legal Services Act that the current framework will not meet. In addition, there are many areas where the Act gives some discretion as to what may or may not be included in licensing rules. In this section, we identify some of these issues and, where possible, give an indicative early view as to what the SRA's approach might be. We would be interested in your views.

A. Reserved/non-reserved legal activities

A.1 Where legal services are provided by solicitors, whether in traditional firms or LDPs, all the services provided by that firm are subject to regulation and the relevant consumer financial protections, such as mandatory insurance, access to a redress scheme and a compensation fund in the event of dishonesty. The Legal Services Act only requires an ABS to be licensed if it is providing reserved activities. In the SRA's view, to promote clarity for consumers the scope of regulation of ABSs should extend to any non-reserved legal activities provided by that ABS (including business and personal advisory services of a type provided by solicitors). Section 71(1) of the Legal Services Act 2007 refers to Part 5 of the Act having effect "for the purpose of regulating the carrying on of reserved legal activities and other activities by licensed bodies."

A.2 Given that the models for ABSs in the future will not only include the ring-fenced model but may also allow for the multidisciplinary model, the SRA would not propose that it should regulate activities that are clearly not legal services. It would not appear to be in the public interest for Approved Regulators or Licensing Authorities to purport to regulate services in respect of which they have no experience and no expertise. In such circumstances, the application of the Code of Conduct and other rules would have to be limited in some way to the legal services.

A.3 However, the key issue relating to the distinction made in the Act between reserved and non-reserved legal work, is that an ABS may in future apply for a licence simply for a body which delivers reserved legal work, whilst providing non-reserved legal work through a related but unregulated body. We think this is a key public and consumer education issue that should be considered carefully by the Legal Services Board and its Consumer Panel.

A.4 The SRA regulates traditional solicitors' firms and LDPs as "recognised bodies", whether they do reserved work or only unreserved work. If the SRA becomes a licensing authority, it will regulate solicitors' ABSs which do reserved work. It would be an anomaly if the SRA were not to regulate solicitors' ABSs which confined themselves to unreserved work. Consumers might rightly expect that the use of a firm of solicitors implied that the organisation was properly regulated.

A.5 Currently, the separate business rule, which is part of the SRA's Code of Conduct, prevents practising solicitors from providing non-reserved legal services (in the narrower sense of drafting legal documents and giving legal advice) through a separate business which is not regulated. Thus, the SRA's current Code of Conduct provides, in effect, that solicitors, as professionals, ought to want to provide key client consumer protections when providing core legal services, even though

- non-solicitors can provide such services without regulation;
- non-practising solicitors could, for example, set up a will-writing business without any reference to their professional qualification; and

- practising solicitors can “hive off” more general business or personal advisory work to an unregulated business.

We do not believe that it would be in the public interest, through the introduction of the ABS regime, to change the current market in such a way that, in future, market forces require all unreserved legal services to be provided through unregulated entities, thus depriving consumers of many of the protections they enjoy now.

Our initial view is that the separate business rule, although criticised by some as a restrictive practice, in fact ensures that more consumers of legal services benefit from important consumer protections and, so, should be maintained. Can the same rule apply to ABSs?

B. Is there anybody who should not be able to be licensed or own an ABS?

B.1 Clementi suggested that there may be certain types of organisation whose interest is adverse to the interests of clients and which may be prevented from owning a law firm or prevented from owning a law firm which acts for clients in certain situations where their interests are adverse to the owner. We believe this latter situation can be dealt with by conflict of interest rules, which may result in some restrictions on the services offered by the ABS—in much the same way as the conflict rules apply certain restrictions upon existing law firms. We would start by asking whether there are any types of business which might in all other ways be fit and proper, which should be prevented from owning an ABS? We cannot think of any, although it has been suggested that claims management companies whose business involves “cold calling” (and who cannot under current rules provide referrals to solicitors’ firms) should not be able to own a solicitors’ firm.

C. How will we take into account the object of improving access to justice?

C.1 This provision was included in the Act in part to deal with concerns that large commercial providers may drive other forms of legal services provider out of business and this may have a negative result on access to justice. The Act starts on the basis that access to justice or access to legal services will be improved through ABSs.

C.2 We believe it would not be proportionate to impose a requirement relating to access to justice on all new providers. The SRA (and previously the Law Society) has not attempted to fetter access of new law firms to the market, even though the possibility of access to justice issues arising from competition have always existed.

However, because the introduction of ABSs may result in more dramatic changes to the market, it would be possible to require certain applications to be subject to an objection process which may then require a market or economic analysis to be made in such a case. How the analysis should be determined is something requiring discussion with a wide range of groups, including the LSB and Office of Fair Trading, whose powers under

competition legislation extend to the delivery of legal services. Such a system would require, we believe, some form of definition of access to justice. Does access to justice mean access to all legal services or to a narrower range of legal services? How could the needs of particular groups, especially vulnerable groups, be safeguarded?

D. Equality and diversity within the legal profession

D.1 The purpose of the introduction of ABSs is to improve consumer choice and value, and if this objective is achieved there will be benefits for disadvantaged sections of the community. There is inevitable uncertainty at this stage about how the legal services market will develop, and it will be necessary throughout the development of the ABS regime to consult and research the potential effects, and to undertake impact assessments. There is the possibility of negative impacts for some sections of the community if, for example, the development of ABSs led to a reduction in the geographical spread of law firms, with consequent access problems, though this might be offset by the development of alternative means of accessing legal services.

D.2 In the absence of an economic assessment of the likely changes to the legal services market caused by the introduction of ABSs, it is hard to assess what impact their introduction might have upon diversity within the profession. ABSs offer advantages to small as well as large organisations.

D.3 As far as the legal profession is concerned, the concentration of BME solicitors in small firms means that there would be a disproportionate impact upon BME solicitors if the introduction of ABSs were to lead to a reduction in small firms. However, this is far from inevitable, and ABSs may lead to the introduction of networks of small firms with advantages for consumers and solicitors. Again, impact assessment will be required.

D.4 Given the existence of significant disparities between different groups in the profession, a full equality impact assessment will be required before decisions are taken about the licensing regime for ABSs, as well as continued monitoring of the impact on the profession and the consumer.

D.5 The SRA proposes that the current equality and diversity requirements set out in the SRA's Code of Conduct should be applied to ABSs, that compliance with these should be monitored, and that the effect of ABSs on the SRA's regulatory regime should be monitored for equality and diversity consequences as part of the SRA's equality and diversity strategy.[6]

E. The fit and proper test for external owners

E.1 The Act requires the fit and proper test to take into account probity and financial soundness. We do not believe it is practical to require positive tests but would be interested in views or examples of where such tests have worked well in other regulatory environments. The current process of the SRA, which is similar to that of the FSA, is to require the disclosure of

[6] See www.sra.org.uk/equality.

information of a sort which may demonstrate a lack of probity or a lack of financial soundness, and to make decisions on that basis. Broadly, we will look carefully at FSA requirements to ensure that we do not put unnecessary obstacles in the way of reputable companies owning an ABS but giving ourselves the ability to make checks where necessary.

E.2 The Act provides that external owners who own broadly 10 per cent of an ABS should be subject to a fit and proper test. The Act permits that percentage to be changed, and for a licensing authority to provide for additional tests for those who, under licensing rules, own a "controlled interest". This suggests that we could, for example impose additional tests above the basic "fit and proper" test to those who, say, own more than 50 per cent of an ABS. Additional safeguards might be needed when levels of control change (e.g. if a person's 33 per cent stake were to be increased to 51 per cent). We would be interested in your views.

E.3 We also consider that external owners should be allowed to own up to 100 per cent of an ABS, subject of, course, to the approval process where appropriate.

F. Adverse interests

F.1 The Legal Services Act does not refer specifically to adverse interests between owners and potential clients of an ABS. However, we believe it is important to identify circumstances where there may be an adverse interest and to regulate accordingly, either by preventing the ABS from acting for a client who may have an adverse interest with an owner or by requiring additional safeguards perhaps to be audited by the Head of Legal Practice. Where there is no clear adverse interest but a potential for adverse interest, as some have suggested may be the case with legal expenses or some other types of insurer, it may be that additional safeguards should be required.

F.2 Do some claims management companies or third party funders have potential adverse interests? Do some financial services providers, such as lenders have an adverse, or potential adverse, interest if providing legal services to borrowers?

F.3 We would be grateful for your views on adverse interests both where they might exist and what safeguards would manage the risk.

G. The role of managers, HOLPs and HOFAs

G.1 The Act permits licensing rules to require a majority of the managers of an ABS to be lawyers ("authorised persons"). We do not believe that this will be necessary in all cases, but may be a matter to consider in particular areas such as the one mentioned above where there is a potential for an adverse interest between an owner of a firm and some clients.

G.2 We need to give further consideration to the roles of the Head of Legal Practice (HOLP) and the Head of Finance and Administration (HOFA). The roles need definition and assessment as to what competencies the role holders need to demonstrate and to show how they should discharge their responsibility.

G.3 Should those competencies be demonstrated through some form of qualification? While a HOFA in a large commercial ABS is likely to be a qualified accountant with a number of years' experience at Finance Director level, that may not be necessary in the context of a very small ABS on the High Street where such qualification requirements may be disproportionate.

G.4 We think that what is more important in relation to these roles is that they have the appropriate accountability and responsibility. It is, we believe, more important to give consideration to corporate governance in ABSs, so as to ensure that the HOLP and HOFA have the tools and authority to do the job that is appropriate in each ABS. Should it be a requirement, for example, that these roles are fulfilled by partners/directors/members, or can they be employees?

G.5 A further question, given our view that broadly the same protection should apply to all firms providing legal services, is whether or not there is any merit in requiring traditional law firms, and LDPs involving only lawyers, also to have to designate HOLPs and HOFAs.

H. Multidisciplinary practices (MDPs): Different service combinations

H.1 We indicated earlier that we believe that we would not want to restrict ABSs to a form of entity that is ring-fenced and provides only legal services, however broadly defined. That, it seems to us, would lose some of the advantages envisaged by the objectives of the Act. That gives rise to the question as to whether any service combinations should be prohibited. Debates about MDPs have usually identified audit and legal work as being incompatible within one organisation because the duty of disclosure of the auditor role conflicts with the duty of confidentiality owed by the lawyer. We would be grateful for your views.

I. Insurance requirements

I.1 Licensing rules need to include appropriate indemnification arrangements. The SRA currently requires all firms to have insurance up to specified levels per claim, provided by an insurance contract that meets minimum standards. This form of insurance provides a high level of consumer protection for clients of solicitors and SRA-regulated LDPs. Our starting principles in Part 2 suggest that it would be appropriate to provide the same level of protection to clients of ABSs. We do not believe that the fact of external ownership by "fit and proper" non-authorised persons should lead to insurers viewing the risk of civil claims against an ABS being very different from the risk in traditional solicitors' firms. Indeed, some insurers may see some external ownership and capital as allowing firms to improve risk management. However, we anticipate some questions as to whether it is appropriate or possible maintain an "Assigned Risks Pool" for ABSs, and we would be interested in your views on that. The Assigned Risks Pool currently exists to provide insurance cover for claims relating to firms who are unable to buy insurance on the open market. If there is no Assigned Risks Pool, then further thought will need to be given to what happens when an ABS fails to obtain insurance and, so, must close.

I.2 A key difference would be in providing insurance to a multidisciplinary practice—the third model referred to in Part 3. Our suggestion is that insurance to the required level would only be **compulsory** to cover legal or solicitors services—on the basis of a broad definition, but not any services that are clearly not legal. Other regulated non-legal services may be subject to minimum insurance requirements of other regulators or may not require any insurance. We believe insurers would be willing to provide insurance distinguishing between different services provided by one entity. We also believe that clients should be made aware where different levels of insurance apply to different services provided by the same firm.

We would be interested in your views on what the insurance requirements should be for ABSs.

J. Compensation fund requirements

J.1 Licensing rules must contain appropriate compensation arrangements. Parliament, through the Legal Services Act 2007, amended the Compensation Fund powers of the SRA to enable it to modernise the operation of the Compensation Fund and make it more flexible and able to deal with LDPs. We believe that such a scheme would be appropriate for ABS.

J.2 Indemnity and compensation requirements for ABSs are interlinked. If the current minimum conditions for insurance are maintained, then the circumstances in which the failure of an ABS may lead to claims on the Compensation Fund, as opposed to insurance, are likely to be even less frequent than now. If that is the case, then it may be possible to maintain one fund, with contributions from all those entities regulated by the SRA—or to split the fund. This is an area that requires more work—but we would be interested in early views.

J.3 If the current minimum conditions for insurance are reduced for ABSs, then the circumstances in which the failure of a firm may lead to a claim on the Compensation Fund (e.g. for uninsured loss caused by negligence) will increase. If that were to be the case, then the need to create two funds would be greater.

K. Clarity for the consumer (descriptions)

K.1 In Paragraph A above we refer to the potential for significant confusion for consumers between regulated and unregulated providers of legal services. In our response to the LSB draft Business Plan, we suggest that early research into consumers' understanding on this would help all approved regulators and licensing authorities to use descriptions which help the public to distinguish between different providers. Traditionally, consumers (knowingly or not) have been able to rely on particular titles, such as "solicitor", because they have been protected titles. We believe that should continue into the future—i.e. only bodies which are regulated by an Approved Regulator or Licensing Authority (and have at least one solicitor "manager") can use the title "solicitor", probably in conjunction with other titles.

K.2 However, increasingly, “Regulated by (… the SRA)” will become significant, and consumers should be educated to recognise the significance of such statements. This is an area where the LSB can take the lead in consumer education, as there needs to be a common regulatory stance set for all approved regulators and licensing authorities. What do the words “lawyer” or “Legal Services / Advice” mean to consumers? We believe that many consumers will assume that any business using such terminology will be regulated, whereas many now are not—and may not be in the future.

L. Conflict between different regulators

L.1 Licensing rules must contain provisions as to how regulatory conflicts between regulators will be avoided. Our regulatory framework for LDPs avoids conflict by applying rules to both the entity itself and to all managers and employees. Essentially, entity regulation, which is the underlying premise of the LSA, avoids conflict by making the entity regulator’s rules “trump” the rules of a different regulator of any individual in the firm in the event of a conflict. This is confirmed by sections 52, 54 and 103 of the Legal Services Act. In any ABS model where legal services are ring fenced from the delivery of other non-legal services, we believe this form of entity regulation deals with the potential for conflict.

L.2 Firms regulated by the SRA which provide mainstream financial services are also regulated by the FSA. Rarely does the situation cause any difficulty or conflict, as each regulatory framework is developed with an awareness of the other regulatory regime.

L.3 It is the third model—the multidisciplinary model—which is most likely to create the potential for conflict. However, as indicated in paragraph 5.6 and paragraph A.2 above, the potential for conflict can be reduced by, where possible, only regulating “legal services” and leaving other regulators to apply regulation to other services. In practice, many other regulators (including the FSA) already regulate in a multidisciplinary context. Examples of real conflict are not common. We will engage with other regulators to assess the best way forward, but would be interested in views as to whether the problem of conflict among regulators is a major concern—or one which can be dealt with through the application of common sense as above.

M. Special and low risk bodies

M.1 The Act gives licensing authorities the power to modify the application of rules to special or low risk bodies—independent trade unions, not for profit bodies, community interest companies and low risk bodies. The principle underlying this is that such bodies are not commercially motivated, reducing the perceived risks relating to external ownership. Low-risk bodies are bodies where non-authorised persons own and control less than 10 per cent of the ABS, and are less than 10 per cent in number of the managers. The principle underlying this is that such bodies are “all but” traditional law firms and can safely be regulated as such.

M.2 The modifications permitted include not requiring such bodies to have a HOLP or HOFA. The Act provides for the modification to be made on the individual application of bodies within the section, and for the Licensing Authorities to have regard to the nature of the legal activities provided and the nature of the persons to whom they are provided.

M.3 We will need to provide for an application procedure for special bodies in licensing rules—while, in the medium to longer term, it would be sensible for rules to set out quite clearly the circumstances in which certain bodies are entitled to a set of modifications, it may be sensible to start on the basis of dealing with each application on its merit, and to build experience which can then be translated into clearer rules.

M.4 In relation to low-risk bodies, given that we have adjusted our current framework to regulate LDPs with up to 25 per cent non-authorised persons, we consider it would meet the regulatory objective to regulate low-risk bodies as LDPs—without additional ABS requirements. We would be interested in the views of any potential special bodies who might apply.

N. Other perceived risks?

N.1 A new risk presented by some ABS models will be that of financial collapse, perhaps for reasons unrelated to the ABS business. Collapse could be caused by the financial predation of an external owner, or by failure of an external owner's other business interests.

N.2 The financial regulation of traditional solicitors' firms has concentrated on protection of client monies, and insurance and compensation schemes to ensure that clients do not suffer financially after the collapse of a firm. Intervention powers give the SRA the power to take over the files and monies in a collapsed firm to ensure that any live files are passed as quickly as possible to firms who can act for the client. Clearly, the whole regulated community must pay for the cost of such collapses.

N.3 The circumstances which may lead to the collapse of an ABS firm may be increased by the risks of external ownership. Should we therefore consider a duty of sound and prudential financial management, ensuring that the ABS is financially self-sufficient—and cannot suffer, for example, through unwise dividend payments to shareholders, or over-complex or inappropriate corporate structures creating interdependencies on unregulated companies? We have seen collapses of companies such as Claims Direct and The Accident Group, which in their turn had a considerable impact on the solicitors' firms on these companies' panels. We do not believe that requirements relating to "capital adequacy", which can present a considerable barrier to entry, can be justified.

Are there any safeguards additional to the "fit and proper" requirements which we should consider?

How to respond

We are in interested in your views on

- the discussion points raised throughout this discussion paper, and
- our initial approach to the issues listed in part 5 (A to N).

You can submit your response either by email or by post to.

For our telephone numbers and opening hours, and our email and postal addresses, please visit www.sra.org.uk/contact-us.

There is no prescribed format for responses. However, please

- identify yourself, and
- advise us if you do not wish your name or the name of your firm or
- organisation to appear on the published list of respondents.

The consultation period ends on 31 August 2009.

Appendix A

Alternative business structures: Examples of some possible models

Model 1 – LDP plus

- LDP comprising three lawyers and one non-lawyer "manager"
- No external ownership

All existing LDPs with a non-lawyer "manager" will need to become an ABS. The sort of practice this model might apply to would be, for example, a firm which has taken on as a "manager" its former HR head, IT head or head of finance.

Model 2 – Totally externally owned; owner has no interest in supply of ABSs services

- 100 per cent external ownership of ABS
- External owner has a commercial interest only in the ABS - i.e. although the external owner has a commercial interest in the financial fortunes of the ABS, it has no interest in supplying products through it (for example, litigation funding,) to clients of the ABS

The ABS would be a ring-fenced legal services arm of the parent external owner. The ABS could take advantage of the parent's corporate brand (e.g. "Nike Law" or "Fortnum and Mason Law").

Model 3 – totally externally owned; owner has an interest in supply of ABS's services

- 100 per cent external ownership of ABS
- External owner has interest in legal services provided by the ABS to clients

The ABS would be ring-fenced and branded as in Model 2. The parent external owner may have an interest in, for example, cross-selling insurance products, litigation funding and other financial or other services to clients of the ABS as a component part of the legal service supplied to clients. The external owner may be regulated by a regulator from a different sector (for example, the FSA in the case of banks or other financial service/insurance providers, or the Ministry of Justice in the case of claims management companies) - for example, "HSBC Law". Or, there could be no specific sector regulator in the case of, for example, a motoring organisation or an estate agency. In both cases, there is an assumption that these offer no other services requiring regulation. A fictional example might be "Motoring Law".

Model 4 – Multidisciplinary practice (MDP)

- A one-stop shop comprising “managers” from legal and other professions providing legal and other services to clients
- No external ownership

The ABS would be a joint practice of lawyers and non-lawyers who would share the fees received for the delivery of legal and non-legal services to clients. This could be, for example, a niche property practice with surveyors, architects, town planners, property managers, builders, decorators, furniture removers and conveyancers. The SRA would regulate only the legal services; other professionals would be regulated by their own regulators.

Model 5 – Co-op model (external ownership, legal and non-legal services)

Using a corporate brand, for example, one firm provides funeral services, will-writing services and probate services; or the ABS could provide a mixture of social welfare advice, administration, and legal services.

The SRA might license the body but regulate only the legal services.

Model 6 – Private equity investment

- Legal services firm with partial private equity ownership

Representatives of the private equity house might become members of the ABS incorporated practice, and the private equity company may hold shares in the ABS.

Model 7 – Floated company

The ABS firm might be floated on AIM/stock market—subject to stock market/corporate governance rules.

Model 8 – Hub and spoke

Non-licensed hub—an administration company for “back office” services (such as changing documentation), but could include some intellectual services. The hub would receive a service charge from the regulated spokes which provide the legal services—could be national franchise or network arrangement.

- Firms can outsource work now, such as accounts, IT, typing
- Hub could be licensed, and may need to be in some cases

Model 9

Model 2 or Model 3 with more than one ring-fenced company (100 per cent external ownership)

- External owner owns more than one ring-fenced law firm
- Need to manage conflicts of interest

Model 10

Not for profit organisations providing legal services (e.g. charities, Citizens Advice Bureaus)

Model 11

In-house teams expanding into the market (e.g. local authorities)