Legal Services Act: New forms of practice and regulation

Consultation paper 6

Client financial protection

27 February 2008

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Introduction

1. We are developing our regulatory framework to allow firm-based regulation across the board, and to allow the new forms of practice permitted under the Legal Services Act 2007 (LSA)—legal disciplinary practices (LDPs) and alternative business structures (ABSs). We hope LDPs will become available in 2009. ABSs are unlikely to be possible until 2012 or 2013.

2. In November 2007, we published Legal Services Act: New forms of practice and regulation—a policy paper which outlines our initial thoughts on the principles which should guide the development of the new regulatory framework. It contains background detail and a glossary of terms which you may find useful when reading this and future consultations. It is available at www.sra.org.uk/LSA.

3. The present consultation asks how client financial protection policy should be developed to accommodate LDPs and other new regulatory arrangements under the LSA, such as the requirement for partnerships to become recognised bodies. We want to identify situations that might arise when it is not clear what responsibilities should properly fall to the SRA, and hence what obligations should fall on Qualifying Insurers under the SRA's compulsory indemnity insurance scheme.

4. Timescales are tight. Although the earliest that LDPs will be permitted is likely to be 1 March 2009, that date falls within the 2008/2009 indemnity period which begins on 1 October 2008. We are discussing with the Qualifying Insurers the scope of the Minimum Terms and Conditions of cover for that period, and by May 2008 we must tell them the changes that are likely to be brought in during the 2008/2009 indemnity period. This will give them sufficient time to prepare their documentation in time for the renewal period.

5. The relevant main features of the compulsory professional indemnity scheme are set out in Annex 1.

Regulatory powers

6. As the regulatory arm of the Law Society, we currently have the power to regulate

   - solicitors
   - registered European lawyers (RELs)
   - registered foreign lawyers (RFLs)
   - recognised bodies (LLPs and companies)

7. Therefore, we also have the power to regulate partnerships (because we regulate the partners) and sole practitioners (even if they do not have practising certificates). We do not have the power to regulate companies or LLPs that are not recognised bodies.

8. The effect of the LSA is to extend the list to include

- recognised sole practitioners
- employees of solicitors and employees of recognised bodies
- managers (principals) of recognised bodies
- partnerships as recognised bodies provided they have at least one solicitor or REL manager (principal)
- non-solicitor managers (e.g. barristers or non-lawyers)

9. Existing partnerships and sole practices operating in accordance with the rules will be "passported" to the status of recognised bodies and recognised sole practitioners respectively. Subsequent applications for initial recognition will involve consideration by the SRA of the suitability of the partnership or sole practice, and the exercise of the SRA's discretion, just as currently happens with LLPs and companies which apply to become recognised bodies.

10. Under our statutory powers we will be able to continue to regulate sole practitioners and partnerships that fail to seek recognition. We will still not be able to regulate bodies corporate (LLPs or companies) unless they are recognised bodies, because we will still have no statutory power to do so. This is a very important distinction that should be borne in mind when reading the rest of this consultation paper.

Whether to act as default regulator

11. To protect the public interest, we may wish to act as the default regulator in some situations. In this context acting as "default regulator" means providing the public with some degree of financial protection in circumstances where a regulated individual (e.g. a solicitor or registered European lawyer) practises through an unrecognised entity.

12. One might suggest that we should adopt a uniform approach. Such an approach might suggest that we should act as default regulator either in all circumstances or in no circumstances. At the very least such an approach would require that if, in a particular situation, we act as default regulator for one purpose (e.g. professional indemnity insurance), we should act as the default regulator for all purposes (e.g. including accounts rules, Compensation Fund, etc.).

13. On the other hand, we might decide that this uniform approach should take second place to the objective of protecting the public. It might be desirable to provide public protection as a default regulator in some circumstances even though this cannot be done in all circumstances. It might be lack of statutory powers which prevents public protection being given in every circumstance, or it might be that to attempt to provide public protection in every circumstance would expose the insurance market and/or the Compensation Fund to unacceptable levels of uncertainty.

The structure of "the profession"

14. As a starting point one needs to examine the scope of our duty to protect the public through regulation of the profession. In particular, the phrase "the profession" has a number of different elements, in respect of which the public may merit protection in different ways and to a different extent. The various categories of "the profession" we regulate are:

A. solicitors – supervision of solicitors is the reason we exist, and we are involved in other types of regulation only as a consequence of our role in relation to solicitors;

B. RELs and RFLs – those lawyers who are not solicitors, but who are nevertheless individually authorised by the SRA - RELs and RFLs; we have a high level of public duty in relation to those individuals because it is the SRA that authorises them;

C. entities authorised by the SRA – that is, solicitors' or RELs' bodies corporate as currently recognised under section 9 of the Administration of Justice Act 1985 (AJA), and the other types of recognised body that will be recognised under the changes made by the LSA 2007: partnerships, LDPs - and recognised sole practitioners; the scheme of the LSA 2007 is that we will be held to account by the LSB for the level of public protection we provide in respect of such entities;

D. unauthorised partnerships/sole practices that can only be authorised by the SRA – entities that are eligible for recognition by the SRA, and would not be eligible for authorisation by another approved regulator (e.g. a partnership of solicitors, or a mixed partnership of solicitors and licensed conveyancers which is doing both litigation and conveyancing), but have not obtained our recognition as a recognised body; at this point we are starting to descend the scale of our responsibility, but it is still possible to argue that we have some responsibility for protecting the public in relation to such entities;

E. unauthorised partnerships/sole practices that can be authorised by the SRA or other regulator – entities that are eligible for recognition as above and which are not recognised by the SRA or any other approved regulator, but would be eligible for recognition either by the SRA or by another approved regulator (e.g. a partnership of solicitors and licensed conveyancers which is doing only conveyancing); it would be difficult to maintain that all such entities are the responsibility of the SRA for all purposes;

F. entities authorised by another regulator – entities that are eligible for recognition as above and are not recognised by the SRA but are authorised by another approved regulator (e.g. a partnership of solicitors and licensed conveyancers which is doing only conveyancing and is authorised by the Council for Licensed Conveyancers (CLC)); arguably the SRA should accept no responsibility even for solicitors practising in such entities;

G. **unauthorised entities that cannot be authorised by any regulator** – bodies through which solicitors or RELs are improperly providing legal services to the public, but which are not eligible for recognition – e.g. because they are 50% controlled by non-lawyers; this type of entity gives rise to the greatest levels of uncertainty and on that ground alone we may wish to steer clear of providing protection even for solicitors practising in such entities.

15. The current proposals are intended to bring in the changes necessary to effect the regulation of LDPs, and to cover other new regulatory arrangements under the LSA, such as the requirement for partnerships to become recognised bodies. There is no intention to bring in other substantive changes to the rules at the same time.

Compulsory professional indemnity

16. We seek your views on how the compulsory professional indemnity insurance scheme, (which is already firm based) should apply to categories A to G above.

Categories A & B – individual solicitors, RELs and RFLs

17. On the grounds set out in paragraph 15, our view is there should be no change: individual solicitors (A above), and individual RELs and RFLs (B above), should continue to be covered by compulsory professional indemnity insurance through their firms (or not covered at all, as in the case of in-house practice, practice overseas, solicitors acting for friends and family without charge, or RFLs practising as foreign lawyers with no involvement of solicitors or RELs).

Category C – entities authorised by the SRA

18. We believe that all the entities we authorise (C above) should be subject to the compulsory insurance requirement- (partnerships, LLPs and companies recognised under section 9 of the AJA and "recognised sole practitioners" authorised under section 1B of the Solicitors Act).

    This will not be affected by the fact that some "managers" (i.e. Principals) of recognised bodies will in future be other types of "lawyer" such as barristers or licensed conveyancers, or even non-lawyers. Such persons are already covered by the scheme as employees. The work that we permit a recognised body to do will continue as it is now—i.e. solicitors' work, foreign lawyers' work and notaries' work.

Category D – unauthorised partnerships/sole practices that can only be authorised by the SRA

19. Category D above covers entities that are eligible for recognition only by us, and would not be eligible for authorisation by another approved regulator. In other words, these entities should be authorised by the SRA but are not. There are two possible approaches:

D1 – No cover for unrecognised partnerships or unrecognised sole practitioners

We could reject the role of a default regulator, and provide no cover for unrecognised partnerships or unrecognised sole practitioners. It could be argued that this would depart from one of our criteria, in that would mean a fundamental change in the current operation of the scheme. Currently a sole practitioner who does not have a practising certificate, or whose practising certificate is suspended or cancelled but who continues to practise, is covered by the compulsory insurance scheme (including the "side arrangement" with the Qualifying Insurers). Perhaps more importantly, all solicitors' partnerships are currently covered by the scheme, whereas if a "recognised entities only" criterion were applied, protection would be removed from the clients of some solicitors' partnerships because the partners have omitted to obtain or renew recognition.

However, this approach would remove the anomaly of the mismatch in protection as between unauthorised LLPs/companies on the one hand and unauthorised partnerships and sole practices on the other. It would also provide the certainty and clarity which is being sought by the Qualifying Insurers. Clients would need to be able to check that we recognise a firm, but the reality may be that a firm that has failed to realise that it should be recognised, or has forgotten to renew its recognition, will nevertheless put on its notepaper that it is 'regulated by the SRA', thinking thereby to comply with the rules.

D2 – Cover for partnerships and sole practitioners whether recognised or not

The alternative approach is that a category D partnership, or sole practice, should be covered by the compulsory indemnity insurance scheme (including the "side arrangement" with the Qualifying Insurers) in order to protect clients, even if it has not obtained recognition by the SRA. It could even be argued that if we are allowing such an entity to practise unrecognised, we are partly to blame for failing to enforce compliance. Accepting this scope of cover under the rules would represent the least change in the scheme. However, it would involve an inconsistency in that an unrecognised company or LLP cannot be covered by the scheme because we have no power to do this even though unrecognised partnerships and sole practitioners can be covered.

We looked at this question by considering what clients may reasonably expect within our powers, and we prefer the D2 approach.

Category E – unauthorised partnerships/sole practices that can be authorised by the SRA or other regulator

20. Category E above is different, in that the entities concerned (partnerships or sole practices) could either be recognised by us or authorised by another approved regulator (e.g. a partnership of solicitors and licensed conveyancers which is doing only conveyancing), but they have failed to obtain any authorisation. This is the trickiest of the cases, and at least four basic approaches are possible:

E1 – Reject default regulator role

The first approach is to reject the role of a default regulator altogether (as in the first option under D above), and to confine the coverage of the compulsory insurance scheme to recognised bodies and recognised sole practices.

E2 – Accept default regulator role in all category E cases

The opposite approach would be to accept the role of default regulator in all category E cases. On this basis a category E partnership which has not obtained authorisation by any approved regulator should be covered by our compulsory indemnity insurance scheme (including the "side arrangement" with the Qualifying Insurers) in order to protect clients. An argument against this is that it presupposes that the SRA is willing to take on the whole burden of client protection in such cases without looking to other regulators to share that burden.

E3 – Cover personal liabilities of individuals whom we authorise

An intermediate approach would be to cover only the personal liabilities of solicitors, RELs and RFLs who are partners or employees within a category E partnership. This is inconsistent with a firm-based approach to regulation and would also represent a fundamental departure from the current arrangements. It might also be difficult to do, and would create uncertainties as to insurers' liabilities in particular situations. For this reason, we reject this approach.

E4 – Dominated by individuals authorised by the SRA

An alternative intermediate approach would be to accept the role of default regulator, but only in those circumstances where a category E partnership is dominated by individuals authorised by us (solicitors, RELs, RFLs). The object would be to protect clients without either us or the Qualifying Insurers taking on responsibilities which properly belong to other approved regulators. The hope would be that other approved regulators would then adopt a similar approach.

E4.1 – Majority test

The test could be a simple 50%+ test - a partnership in which a majority of the partners are solicitors, RELs or RFLs. Such a test could however leave clients unprotected in some circumstances.

E4.2 – Largest group test

Alternatively the test applied might a "largest group" test under which each regulator takes on default responsibility for firms in which lawyers authorised by that regulator are the single largest group of partners, either in terms of number or equity holding. A test depending on the number of individuals would be easier to apply and would make for greater certainty than one based on equity holdings. The question remains which, if any, regulator should take responsibility for a firm within category E in which there is no single "largest group" of lawyer partners but in which the two or more largest groups are of equal size. There seems to be two workable possibilities:

E4.2.1

No regulator should take responsibility. This seems irrational, and contrary to the public interest.

E4.2.2

The regulators of each of the "equal largest" groups should share responsibility. For this to work, the SRA would need to seek formal agreements with other approved regulators as to coverage of claims against such partnerships. The rules would require solicitors, RELs and RFLs practising in such a partnership to take out Qualifying Insurance for such a firm unless they have obtained authorisation from another regulator. If they have failed to comply with this obligation, the firm would be a Firm in Default but, as an exception to rule 15.1(a), the "side arrangement" under the Qualifying Insurer's Agreement would exclude cover for claims against such a firm unless there is an agreement between the two (or more) approved regulators to cover such claims.

Partnerships which do not meet whichever test is adopted would fall outside the SRA's compulsory insurance scheme - but hopefully would be picked up by the scheme of another regulator. If one of these tests is to be accepted for category E cases, we recommend the "largest group" approach (modified as above to deal with "equal largest groups"), even though we recognise the inconsistency whereby an unrecognised company or LLP cannot be covered by the scheme because the SRA has no power to effect this. To some extent, this mirrors the current scheme, in which sole solicitors and solicitors' partnerships are covered, and so are recognised LLPs and companies, but not unrecognised LLPs and companies.

Category F – entities authorised by another regulator

21. As our professional indemnity insurance scheme is a firm-based scheme it is logical and expedient that firms which are eligible for recognition by the SRA but are authorised by another approved regulator (category F above) should be excluded from the SRA's scheme (e.g. a partnership of solicitors and licensed conveyancers which is doing only conveyancing and is authorised by the CLC). In the event that such a firm fails to have professional indemnity insurance required by the other approved regulator, it would not be covered through the "side arrangement" with the Qualifying Insurers, but would be entirely the responsibility of the other regulator even in respect of the negligence of a solicitor practising through that firm. We believe this meets the reasonable expectations of clients and other parties and with the scheme of the LSA.

Category G – unauthorised entities that cannot be authorised by any regulator

22. Category G bodies through which solicitors or RELs are (improperly) providing legal services to the public, but which are not eligible for recognition by the SRA or by any other approved regulator (e.g. they are 50% controlled by non-lawyers), should not be covered by the SRA's scheme. To extend

cover even to individual solicitors practising through such bodies would open the door to claims relating to a wide range of bodies whose solicitors are acting contrary to the practice rules and/or in a grey area between in-house and private practice. This, we believe, would exceed the reasonable expectations of clients and would bring unacceptable uncertainty for Qualifying Insurers.

Right to seek reimbursement

23. To the extent that we act as the default regulator of any unrecognised firm in order to protect the public, it will be on the basis that, as now, we will exercise our power to seek reimbursement from the firm and from those principals of the firm that are individually authorised by the SRA (i.e. solicitors, RELs and RFLs). Those individuals may also be liable to investigation, disciplinary action and/or criminal proceedings for practising through an unregulated firm.

Compensation Fund

24. It is arguable that, because of the need to maintain public confidence in the solicitors' profession and the "solicitor" brand, the Compensation Fund should continue to be available in the last resort for claims in respect of a solicitor's dishonesty, even if the solicitor is practising in a firm authorised by another regulator. If so, the Compensation Fund rules should make clear that the other regulator is regarded as primarily responsible, and that a claim will only be considered by the Compensation Fund if the other regulator's insurance and compensation arrangements fail for some reason to cover the claim. We would need to adopt measures to ensure that this provision is not used by other regulators as a reason not to cover the dishonesty of a solicitor working within their authorised firms.

25. The contrary view would be that the Compensation Fund should not be available to meet claims in respect of the dishonesty of a solicitor practising in a firm authorised by another regulator, even if the Fund continues to be able to consider claims in respect of dishonesty of a solicitor in any other type of practice.

26. The Compensation Fund with be the subject of a separate consultation exercise.

Accounts Rules

27. One of the most significant client financial protections is that provided by the Accounts Rules which in turn engages the protection afforded by section 85 of the Solicitors Act 1974. Such rules can be binding, under our statutory powers, on solicitors practising in unrecognised partnerships/sole practices - although not on unrecognised LLPs or companies. Would it be justified to withhold that client protection in the case of some unrecognised practices because we cannot effect protection in the case of all unrecognised practices? The Accounts Rules are the subject of a separate consultation.

High level issue of principle

28. We are faced with a decision between two main options in relation to boundary of client financial protection. The first is to reject the default regulator role. The alternative is to accept the default regulator role and then to determine in what circumstances and to what extent client financial protection is to be provided. Both are legitimate approaches. To assist you, the main advantages and disadvantages of each option are summarised below.

Option 1 – Reject the default regulator role.

Advantages

- Simple, clear, unambiguous - rules to apply to recognised bodies and recognised sole practitioners only.
- Likely to be welcomed by the Qualifying Insurers.
- Brings the SRA in step with other regulators.
- Removes the anomaly of the mismatch in protection as between unauthorised LLPs/companies on the one hand and unauthorised partnerships/sole practices on the other (see paragraph 8).

Disadvantages

- It would involve a fundamental change in the current operation of the scheme.
- A reduction in client protection as no cover in respect of unrecognised partnerships or unrecognised sole practices.
- May not be acceptable to public interest stakeholders including the Legal Services Board (once it is established).
- It would imply that the protection of the Accounts Rules should be withdrawn if a partnership/sole practice omits to renew its recognition.

Option 2 – Accept the default regulator role.

Advantages

- No fundamental change in the current operation of the scheme.
- No reduction in the level of client protection.
- Likely to more acceptable to stakeholders.

Disadvantages

- More complicated so potentially more confusing.

- Anomalous as there will be client protection for unrecognised partnerships / sole practices but not for unrecognised LLPs / companies.
- Unlikely to be welcomed by the Qualifying Insurers.
- Other regulators unlikely to be able to adopt similar approach so unfair burden placed on SRA.
- Additional costs fall on Qualifying Insurers and indirectly onto the profession.

Questions

1. Do you agree that individual solicitors (Category A above), and individual RELs and RFLs (Category B above) who are engaged in private practice, should continue to be covered by compulsory professional indemnity insurance through their firms? (Paragraph 17)

2. Do you agree that the compulsory professional indemnity insurance requirement should apply to all firms that we authorise? (Category C above - paragraph 18)

3. Regarding unauthorised firms that only we can authorise, (Category D above), do you think:

   (a) we should reject the role of default regulator so that the compulsory professional indemnity scheme does not cover unrecognised partnerships/sole practitioners (paragraph 19, D1); or

   (b) we should adopt the role of default regulator in that the protection afforded by the compulsory professional indemnity scheme applies to partnerships and sole practitioners whether recognised or not (paragraph 19, D2)?

4. Regarding unauthorised partnerships/sole practices that can be authorised by us or another regulator (Category E above):

   (a) do you think that we should reject the role of default regulator so that the protection afforded by the compulsory professional indemnity scheme applies to recognised bodies and recognised sole practitioners only? (paragraph 20, E1)

   (b) If you believe that we should adopt the role of default regulator, should that be on the basis of: accepting it in all Category E cases (paragraph 20, E2); confining cover to the personal liabilities of those individuals we authorise (paragraph 20, E3) or accepting it only in those cases where the partnership is dominated by individuals we authorise? (paragraph 20, E4)

5. Do you agree that firms that are authorised by another regulator should be excluded from our compulsory professional indemnity scheme? (Category F above - paragraph 21)

6. Do you agree that unauthorised firms that cannot be authorised by any regulator should be excluded from our compulsory professional indemnity scheme? (Category G above - paragraph 22)

7. Do you believe that the Compensation Fund should continue to be available in the last resort for claims in respect of a solicitor's dishonesty, even if the solicitor is practising in a firm authorised by another regulator?

Deadline for receipt of responses

The deadline for receipt of responses is 23 April 2008.

How to respond

For information about How to respond, please visit our website.

- Go to www.consultations.sra.org.uk.
- Select **Client financial protection**.
- Click **How to respond**.

Alternatively, go to http://www.sra.org.uk/consultations/481.article#respond.

Annex 1 – The main features of the solicitors' compulsory professional indemnity scheme

- The relevant Rules are the Solicitors' Indemnity Insurance Rules. The Minimum Terms and Conditions of cover are set out in Appendix 1 to the Rules.

- A Firm carrying on a private practice from offices in England and Wales is required to have a policy of "Qualifying Insurance".

- The purpose of the cover is to provide the public with a good basic level of protection in the event that a firm of solicitors is negligent or dishonest which results in the claimant suffering a loss.

- Qualifying Insurance is available through "Qualifying Insurers". The insurers have to offer policies which meet set Minimum Terms; to participate in an "Assigned Risks Pool" (ARP); and to report suspected dishonesty to the SRA.

- Firms that cannot get cover on the commercial market can apply to be covered, for a limited period, through an "Assigned Risks Pool". Premiums for the ARP are high. Firms in the ARP are subject to monitoring visits and can be required to implement special measures to reduce the risks of claims.

- If a Firm practices without either a policy of Qualifying Insurance or an ARP policy then any claim that arises will be dealt with under a separate arrangement (sometimes referred to as the "side arrangement") with the Qualifying Insurers similar to the ARP under which the Law Society is the insured. This helps provide seamless protection for clients regardless of the failure of a Firm to obtain cover.