



FOIL UPDATE

December 2009

Alternative Business Structures: approaches to licensing

The LSB consults

The Legal Services Board (LSB) has published its next consultation paper in the move towards the Alternative Business Structures (ABS) coming into existence in mid 2011. This paper picks up many of the same issues as the LSB's previous consultation on ABS in August this year. At this stage the LSB's thinking is more developed but it is still a consultation document and views are sought from the profession.

As members will be aware the LSB was created by the Legal Services Act 2007 (LSA). It is responsible for overseeing 'approved regulators' (AR) in the area of legal services, such as the Solicitors Regulation Authority, the Bar Council and the Council for Licensed Conveyancers. The LSA gives the LSB a new power to approve 'licensing authorities' (LA), which will then license "Alternative Business Structures" known as ABS. To date, the Solicitors Regulation Authority and the Council of Licensed Conveyancers have expressed firm interest in becoming LA.

New approaches to regulation

The LSB expects LA to take an "outcomes-based approach" to regulating ABS. The consultation sets out a framework of 'core outcomes' that LA will be required to adopt. This means that regulation is not exercised by strict rules which have to be adhered to: in an 'outcomes based' regime the end result is set out and firms then have flexibility in deciding how to achieve those outcomes. The LSB describes this as "more sophisticated regulation, that moves away from an assessment of whether a rule has been followed and moves towards assessing whether the actions being investigated are likely to achieve the desired outcomes" (although the LSB recognises that in some situations strict rules are required). Guidance may also be provided although it will not be mandatory.

In addition, the LSB is proposing that LA take a "risk-based approach" to regulation which will require them to focus resources in the areas of most need. Although regulation of individuals will still be important the new approach to regulation proposes a much stronger focus on the entity – the systems and activities of the organisation, rather than the behaviour of the individuals within the organisation. Issues such as ownership, corporate governance, finance issues such as client money, insurance and anti money laundering will be considered matters for the firm. Professional ethics, acting in the clients' interests, professional interactions and professional training and

Cracking the acronyms.....

LSA – Legal Services Act 2007, which created the:

LSB – Legal Services Board – the oversight regulator, which oversees the 'front line' regulators including the:

SRA – Solicitors Regulation Authority – an approved regulator(**AR**)and;

CLC – Council for Licensed Conveyancers, another approved regulator (**AR**)

Both the SRA and the CLC are interested in becoming:

LA - Licensing Authorities to enable them to grant licences to:

ABS – Alternative Business Structures with outside ownership.

LDP – are Legal Disciplinary Partnerships, permitted from March 2009, permitting different legal professionals to work together and/or up to 25% non-lawyers.

development will be matters for the individual. Conflicts and duty to the court will be matters for both the firm and the individual. This focus on the firm (the entity) is designed to allow different professionals to work together with a "clear operating environment being overseen by the regulator of the entity".

The LSA allows for the entry of new regulators/LA. Potentially there will be a degree of competition between regulators. The LSB believes that placing that competition in a properly regulated framework will prevent any 'dumbing down' and will allow a regulated organisation to pick the most appropriate regulator for it. The fact that all regulators will be using the same 'core outcomes' is aimed at maintaining standards and avoiding any LA being viewed as a soft option.

Ownership Tests

The LSA sets out a test for non-lawyer managers and owners of ABS, modelled on a similar test under the Financial Services and Markets Act 2000. The LSB has discussed the issue with the FSA and the Gambling Commission to understand how they implement equivalent tests. In the light of the strong ownership tests being introduced there will be no restriction on how much of the business non-lawyers will be allowed to own. The ownership tests will apply to any non-lawyers who own "a restricted interest" - more than 10% of a licensable body or a body that controls a licensable body. Three tests will apply to any non-lawyer holding a restricted interest: a test to ensure that the regulatory objectives will not be compromised, for example, through a conflict of interest; a test to ensure that the non-lawyer owner or manager does not do anything to undermine professional rules or regulatory requirements; and a 'fitness to own' test examining the person's probity and financial position and the person's associates. The LSB considers "that in most cases, people with significant influence are unlikely to have a negative influence on an ABS".

There is a complex test, set out in the paper, to identify a non-lawyer's 'associates', a term which will include family members, employees and associated companies. The LSB accepts that the regulatory requirements surrounding 'associates' may create a considerable regulatory burden particularly on public/listed companies and the paper sets out several methods by which the burden could be reduced, for example through a de minimis rule for associations unlikely to be influential, or a presumption that certain categories of institutional investors are fit to own unless they appear to be acting in concert with one another.

The LSB is concerned that the tests to judge suitability of new owners "should not be overly prescriptive and burdensome in relation to people who give no cause for concern". Instead the proposal is that LA should be in a position to act quickly if there is improper influence.

If a corporate ABS is publically listed its constitution documents should include a clear statement of its regulatory duties. The principle should be that a duty to a shareholder must not compromise the duty to the court and to the client.

Indemnity and Compensation

As professional insurance and discretionary compensation are the main ways by which the consumer receives redress the LSB's starting point is that "customers of an ABS should be no less protected than those in other parts of the market". There are key issues that need to be resolved:

- What will be the insurance requirements for an ABS that undertakes a range of activities;

- Run-off and successor practices –there are fears that the current arrangements may act as a barrier to ABS. For example, a regulated firm wanting to become an ABS but with no successor practice would have to provide six years run-off cover, which may make it easier to set up a brand new entity rather than merge or take over an existing SRA regulated one;
- Compensation funds – whether it is appropriate to require them and how they would work in ABS providing a range of different types of advice.

A number of issues are raised with the current system. It is acknowledged that these are not 'ABS' issues as such but will need to be considered in the development of insurance/compensation principles:

- The very high minimum terms required by the SRA may cause some insurers to decide not to offer professional insurance which may increase the price, and therefore increase costs for consumers.
- The requirement for insurers to pay any excess if the lawyer cannot pay may reduce the incentive on lawyers to feel responsible for paying an excess (although insurers do sue to recover their outlay)
- The SRA's required single renewal date may make it difficult for ABS to get cover from the start date for ABS – mid 2011. The LSB is unlikely to agree to the continuation of a single renewal date in the future.

The LSB is establishing a Task Force with the SRA, the Law Society and other interested parties to consider all the issues raised under Professional Indemnity and Compensation. Possible solutions to the problems include:

- the removal of minimum requirements for cover for ABS;
- the examination of other means of financing a compensation fund, for example, through the interest on client accounts as in Australia, by using a part of the ABS licensing fee or by using bonds and letters of credit.
- Providing better consumer information and education to make the public more aware of the issues and risks.

Reserved and unreserved legal activities

There are only a very limited range of activities that are defined by the LSA as "reserved legal activities". However, currently, solicitors are regulated in respect of any legal activity they undertake whether reserved or not. This creates a situation whereby non-lawyers can undertake unreserved activities without being regulated. The LSB asks whether extending regulation to these non-reserved activities is likely to create more cost and risk than the costs and risk arising from customer confusion if clients do not know whether they are buying a regulated service or not. The LSB is intending to collect better evidence on the level of consumer understanding at present.

The LSB believes that ABS "must provide the same level of consumer protection for reserved and unreserved legal activities as in the current market". In addition "a minimum requirement is transparency for consumers. They should be free to purchase any legal service, including an unregulated legal service, but they must be aware (i) that the legal service being purchased is unregulated and (ii) what protections an LA provides in these circumstances." (Those reading the consultation may feel that it is a tall order to ensure that consumers understand the niceties of the legal market to that extent).

The SRA has indicated that in its view an ABS should be under a duty to ensure that its non-reserved work is regulated in the same way as its reserved activities. The Law Society believes that ABS should be prohibited from setting up separate unregulated firms to carry out unreserved legal work. The LSB states that it will consider in more

depth next year whether unreserved legal advice should be regulated, presumably whether delivered by ABS or non-ABS law firms, but "in the meantime it may be appropriate to retain the current approach to regulating non-reserved activities in non-ABS firms". It does appear that the LSB wishes to maintain a level playing field between ABS and non-ABS firms on this issue.

The LSB wants to avoid a situation where a provider of legal services could escape regulation by creating two businesses, one an ABS that handles only reserved work and the other which provides only unreserved work and is therefore unregulated. In the consultation the LSB sets out various ways to "provide appropriate levels of consumer protection within ABS without unduly extending the scope of regulation or unduly restricting the commercial freedom of an ABS":

- If the ABS has an associated business in which non-lawyers undertake unreserved legal activities, those unreserved legal activities could be regulated if it provides direct access to the consumer, or if the consumer might assume that they are regulated (perhaps because they use the same brand). This would bring into regulation some activities that are not currently regulated which could increase compliance costs although the LSB "anticipates that ABS will want to protect their brand value and will therefore have processes in place to ensure that all advice is of a high standard";
- Alternatively, the ABS could be required to ensure that all unreserved legal activities by unregulated associate businesses are provided to the same standard as its reserved legal activities.

On this issue of the creation of separate businesses it is unclear whether a level playing field is to be retained between ABS and non-ABS firms. Some of the solutions above would enable an ABS firm to run a parallel non-regulated firm offering unreserved work, albeit with conditions on the operation of the non-reserved entity. It is unclear whether non-ABS firms will be able to act similarly, which they are prevented from doing at present.

LA enforcement powers and financial penalties

LAs will have the power to take enforcement action against an ABS. Key powers will include disqualification of employees or managers. It is proposed that the maximum financial penalty should be unlimited.

Access to Justice

This is seen as a key outcome in supporting people both as consumers and citizens and ABS applications will need to explain how the ABS anticipates it will improve access to justice. It is proposed that the LA gather evidence to track the impact over time of the ABS regime on access to justice. This should not just consider the impact on high street firms but should "take a more sophisticated view of the provision of services in all media". Licensing applications will not normally be turned down on the "basis of risks to legal services provided by other suppliers". The LSB has considered whether ABS should be required to provide pro bono work and has decided they should not.

Special bodies

Bodies such as law centres, citizens' advice bureaux, advice agencies and independent trade unions are identified in the LSA as requiring special treatment. The LSB takes the view that such bodies should be subject to regulation where they provide legal services to the general public although the LSA indicates that such regulation can be less burdensome because of the public benefit provided by such organisations and the

perceived lower risk they represent. However, the LSB does not think it is in the interests of the public or the organisations themselves for there to be “significant and prolonged” departures from the essentials of the regulatory regime.

Head of Legal Practice (HoLP)/Head of Finance and Administration (HoFA)

An ABS must have at all times a person in each of the above key positions. The HoLP will be a lawyer with a key role in ensuring that the organisation adheres to the terms of its ABS licence, and that employees and managers meet their professional obligations. The HoFA must ensure that the ABS meets its obligations under the accounts rules and must report any breaches to the LA. The HoLP and the HoFA may be the same individual. Both will be subject to a ‘fit and proper’ person test, whether lawyers or non-lawyers, in the same way as someone who wishes to own an ABS – the tests will not be required to be renewed on an annual basis as that is felt to be excessive. It is likely that both will be required to report to the most senior level of management. There may be a requirement that the individuals undergo training. The information the LA obtains on the experience and qualification of the HoLP and the HoFA will be part of its risk assessment in determining what level of monitoring and enforcement will be appropriate.

Diversity

ABS and other legal services providers may, in the future, be required to meet information requirements as part of a broader strategy to increase the transparency of the legal services profession.

Legal Disciplinary Partnerships

Legal Disciplinary Partnerships (LPDs) which have an element of non-lawyer ownership will become ABS. This includes those firms recognised by the SRA and which have less than 25% non-lawyer ownership. Next year, following consultation, the LSB will seek to modify the legislative framework for LPDs. It is envisaged at this stage that LPDs will have a 12 month period of grace to make the transition to ABS. LPD which consist of different types of lawyer working together without non-lawyer ownership can continue to be regulated as LPDs. The LSB asks if 12 months is sufficient to enable firms to make the transition.

Other issues

The consultation paper also considers the issues of LA enforcement powers and financial penalties, complaint handling, appellate bodies and international issues.

Conclusion

In its previous paper, published in August, the LSB was preparing to license ABS itself in the event that LA were no ready to do so. In its current paper it seems more confident that the LA will be ready. It is clear that the LSB’s enthusiasm for the new structures continues unabated. Upon considering the consultation the reader is struck by the LSB’s optimism and favourable presumptions towards ABS. From the presumption that generally people with significant influence are unlikely to have a negative effect on ABS, through to the presumption that even without regulation ABS offering non-reserved legal activities will want to provide a good service to protect their brands, the new ABS will start life encouraged by the regulator’s belief that they will benefit the public and buoyed by the regulator’s positive assumptions of their good intentions – a regulatory mindset which firms currently regulated by the SRA may envy.

There are other voices expressing more caution with regard to ABS. The shadow justice minister, Henry Bellingham, told delegates at the MASS conference in November that on ABS he preferred an evolution to a big bang. The Law Gazette reported his comments as follows: "If we possible can, we're going to find ways of slowing down the process. We're not going to reverse the Legal Services Act 2007 but we certainly won't move it any further".

Lord Hunt is also more cautious. The view in his report is that it is better to get it done right than to get it done quickly. Whilst not arguing against the 2011 start date for ABS, Lord Hunt believes it is crucial to put safeguards in place. His report recommends that the LSB should not allow approved regulators to issue ABS licences until they have the necessary processes in place to ensure that the public and consumer interests are protected. He comments, "Whereas the LSB has been very sanguine in its approach to ABS, I sense that the SRA has a more acute awareness of the potential pratfalls that lie ahead". He is glad that the SRA has stated its willingness to be the lead regulator. Lord Hunt is also keen to ensure that there should be a level playing field, with ABS not enjoying any unintended or unfair regulatory advantage over non-ABS firms. Lord Hunt takes a tough line on indemnity cover, stating in his report that multidisciplinary practices should have suitable indemnity cover for all the services they provide.

At a recent meeting of the Law Society Council attended on behalf of FOIL by Michelle Penn concerns were expressed that the LSB may present licensing rules as a fait accompli. The Law Society's current policy is one of support for ABS provided there are sufficient safeguards and a level playing field but concerns were expressed at the meeting with regard to maintaining access to justice under the new proposals.

The current LSB consultation closes on 19 February 2010. The full consultation paper can be accessed on:

http://www.legalservicesboard.org.uk/what_we_do/consultations/index.htm

A list of all the questions raised is attached as Appendix 1. Please forward your views and comments to Shirley Denyer at shirley.denyer@foil.org.uk by 22 January to enable a FOIL response to be prepared.

Two further papers will be issued later this year by the LSB:

- "Designating approved regulators as licensing authorities"; and
- "Compliance and enforcement – statement of policy in relation to cancellation of designation as a licensing authority".

This publication is intended to provide general guidance only. It does not give legal or professional advice and is not to be used in providing the same. Whilst all efforts have been made to ensure that the information is accurate all liability (including liability for negligence) is excluded to the fullest extent lawfully permitted for any loss or damage howsoever arising from the use of this guidance.

Appendix 1

The questions raised in the consultation document

1. What is your view of basing the regulation of ABS on outcomes?

- a. Should all LAs have the same core outcomes?
- b. Are the proposed outcomes appropriate?
- c. Is the division between entity and individual regulation appropriate?

2. Do you think our approach set out to the tests for external ownership is appropriate?

- a. Should the tests be consistent across all LAs?
- b. Is our suggested approach to the fitness to own test the right one?
- c. If declarations about criminal convictions are required, should these include spent convictions?
- d. What is your view of our suggested approach for considering associates? Is there an alternative approach that would work better in practice?
- e. Should there always be a requirement to declare the ultimate beneficial owner of an ABS?
- f. Overall, are any modifications needed to ensure that our approach work in a listed company?
- g. Overall, are any modifications needed to ensure that our approach work in very small companies?
- h. Do you think that the definition of restricted interest should change?
- i. Do you think that covenants should be required from those identified as having a significant influence over an ABS?
- j. How should the LSB respond to the information it receives about information on action taken against people that falls short of disqualification?

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3. Do you have views on how indemnity and compensation may work for ABS?

a. How should an appropriate level of PII be set for ABS that are carrying out a variety of different activities, not all of which are currently regulated by the ARs?

b. Should there be minimum PII levels, which are the same for all LAs for different types of activity?

c. Are Master policy arrangements appropriate for ABS?

d. What would be appropriate arrangements for runoff and successor practices to enable sufficient commercial freedom for ABS as well as protection for consumers after practice closure?

e. What should the requirements be for compensation funds in ABS?

f. How could a compensation fund work in an ABS environment, in particular when the services offered by the ABS may be much wider than legal advice and where an AR may not currently have a compensation fund?

4. Do you agree with our position on reserved and non-reserved legal activities?

a. Do you agree that ABS should be treated in a consistent way to non-ABS?

b. Should all legal activities undertaken by an ABS be regulated or just reserved legal services?

c. What role do you see consumer education playing?

d. How should ABS which are part of a wider group of companies be treated?

5. Are the enforcement powers for LAs suitable?

a. What is your view on the proposed maximum level of financial penalty that a LA can impose on an ABS?

b. If you do not consider the proposed maximum to be appropriate what amount or formula would you propose?

c. Will LAs have sufficient enforcement powers?

d. Will ABS have sufficient clarity as to how the enforcement powers may be used?

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- e. In what circumstances should a LA be able to modify the terms of a licence?
- f. Are there appropriate enforcement options for use against non-lawyer owners?

6. What do you think of our approach to access to justice?

- a. Do you think the wide definition to access to justice that we have taken is appropriate?
- b. Is asking an ABS on application how they anticipate that they will improve access to justice a suitable approach?
- c. Do you agree that restrictions on specific types of commercial activity should not be put in place unless there is clear strong evidence of that commercial practice causing significant harm?
- d. Do you agree that LAs should consider how ABS in general impact access to justice rather than trying to estimate the impact of each application singularly?
- e. Do you agree that LAs should monitor access to justice?

7. What is your view of our preference for a single appeals body?

- a. Should, in the future, a single body hear all legal services appeals?
- b. If you don't think there should be a single body, who should hear appeals from LSB decisions should it become a LA?
- c. Is the FTT, GRC an appropriate body to hear appeals?
- d. What other options for the location of the body?

8. Do you agree with our approach to special bodies?

- a. Do you think that special bodies' transitional arrangements should come to an end?
- b. Do you think 12 months after the start of mainstream ABS is sufficient time for them to gain a full licence?
- c. Do you think LAs should adapt their regulation for each special body?

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d. Do you agree there are some core requirements that all special bodies should meet? If so, what do you think these are?

e. What are your views on the suggestion that the OLC should make voluntary arrangements with special bodies?

9. Do you think that our approach to HoLP and HoFA is suitable?

a. Do you think that our approach on focussing on compliance systems across the organisation is suitable?

b. Do you think that HoLP and HoFA should undergo a fit and proper test?

c. Should there be training requirements for the HoLP and HoFA?

d. Do you agree that the HoLP and HoFA could be the same individual (especially in small ABS)?

10. Do you think that our approach to complaints handling is suitable?

a. Do you think that ABS complaints should be handled in the same way as non-ABS complaints?

b. Do you think that ABS should be allowed to adapt their complaints handling systems if they already have one for their non-legal services consumers?

c. Do you think it is appropriate for the OLC take complaints from multi disciplinary practice consumers and refer where necessary?

11. What are your views on our proposed course of action to conduct research and, depending on the results, either compel transparency of data or encourage it?

a. Do you agree with our position on diversity and ABS?

b. Do you agree that the overall impact is unlikely to be adverse to the diversity of the profession?

c. Do you agree that non-lawyer managers may open new career paths to lawyers and these may have a positive impact on career progression?

d. Do you agree that the demand for diverse legal professionals will, largely, offset the potential impact due to the closure of small firms?