City of Westminster & Holborn Law Society

Response to SRA Consultation Paper 18: Regulating Alternative Business Structures

Introduction

1. The City of Westminster and Holborn Law Society ('CWHLS') enjoys perhaps the most diverse membership amongst local Law Societies, encompassing as it does, a membership ranging from larger firms, including those which have been called in recent years "the silver circle" down to small high street practices and individual in-house solicitors, including those working for public bodies and government as well as incorporating a number of highly specialist "niche practices" located in London's West End. Our membership includes those who practice at all levels of the profession, those who regularly represent solicitors in SRA investigations and members of the Solicitors Disciplinary Tribunal. Of particular relevance to this consultation, our membership includes those who have practised extensively in the field of Solicitors' Professional Indemnity Insurance

2. Membership is voluntary and CWHLS is run by a committee comprising 33 solicitors representing a very wide range of specialisms. Its work is carried out by 11 specialist sub-committees, one of which, the Professional Matters Sub-Committee, concentrates on matters such as training of solicitors, their regulation, etc.

3. While the response below was a task initially undertaken by the Professional Matters Sub-Committee, the paper has been approved by the full Committee as being representative of their views.

Preamble

4. CWHLS has considered the consultation papers published by the SRA and by the Legal Services Board('LSB') ("Wider Access, Better Value, Strong Protection"). It is our view that both of these consultations point to the inevitable conclusion that more information is needed from all affected parties before a sensible conclusion can be drawn on the prospect of Alternative Business Structures ('ABS'). It is clear that ABS must be addressed practically and cautiously and, above all, should not have the effect of

damaging the reputation of the profession, both here and abroad. We are strongly opposed to the LSB's insistence that the first ABS licences should be granted in mid 2011, come what may.

5. The advent of ABS is a fact and may well present unique opportunities to legal services providers and clients alike. The approved regulators, and especially the LSB should consider that the introduction of ABS is a big step which presents unique regulatory challenges and which is regarded with immense suspicion by both the regulated community and our counterparts abroad, particularly in Europe and the US. These suspicions can only be assuaged if the regulators are in a position to demonstrate not only that all additional risks have been weighed and addressed but also that the integrity and independence of the English legal system has not been compromised or sold to outside interests.

6. It is on this basis that CWHLS approach the discussion points set out in the consultation paper. We consider that many of the discussion points raise more questions which need to be answered by the SRA and/ or the LSB before a considered response can be given and we trust that the SRA and the LSB will consider the information received and consult further with the profession and interested parties in due course.

7. CWHLS believes that whatever form regulation of ABS ultimately takes, there must be a level playing field for traditional law firms, LDPs and ABS alike. Whilst it is undeniable that regulation should be targeted to the risks presented by each form of practice, it would defeat the object of introducing ABS if the regulatory framework was weighted in favour of one form of practice.

Discussion Points

i) We agree that ABS should not be subject to unnecessary restriction. Careful consideration will need to be given to whether restrictions over and above those provided in the Legal Services Act are necessary in each case.

ii) We consider that further information is needed, in particular from potential investors, other professionals and indemnity insurers to clarify what additional risks are likely

to arise in each type of ABS. It occurs to us that there may be a need for a Memorandum of Understanding with other professional bodies to clarify the edges of the regulatory jurisdictions, combined with detailed consultation with indemnity insurers to ensure that there is appropriate and comprehensive regulatory and insurance coverage to protect clients in the event of negligence or fraud.

iii) We agree that steps should be taken to ensure that the project is moved forward at the appropriate pace. Legislation is in place and a number of firms have expressed interest in setting up as an ABS. Early advent of ABS may help alleviate the effect of the current financial crisis on some firms. That said, there is a lot of work to be done and it needs to be done carefully and thoroughly. Rushed implementation of legislation could lead to unforeseen and damaging consequences which could irreparably harm the profession both here and abroad. Whilst we confess our own reservations about the advent of ABS at all, we accept that it is a reality and express our very strong desire to see that the implementation is neither rushed through without proper appreciation of potential consequences nor unnecessarily delayed.

iv) We agree that the protection provided to consumers using legal services through ABS should not be less than for consumers using "traditional" law firms. We have our own reservations about the current regulatory framework.

v) Not applicable.

vi) No.

vii) No.

viii) We largely agree that the focus should be on outcomes and supervision however we can see the possibility of practical difficulties with certain business models, particularly in relation to areas of practice where there may be inherent conflicts of interest and in respect of indemnity insurance. We do not believe that it is desirable for costs of regulating other professions – or making good defaults of other professionals - to fall on the legal profession through the compensation fund or if there are gaps in indemnity insurance coverage.

ix) This may be the right approach to the prompt introduction of ABS. In our view, it is not the correct approach to the introduction of ABS. The approach set out and, in particular, the definition of "solicitor" services is unworkable. The first step which needs to be taken is to identify what services the SRA will regulate. It is not enough simply to state that the SRA will regulate services normally provided by a solicitor. This may cause potential conflict with other regulators – for example, in an ABS comprising accountants and solicitors providing tax advice, all services provided are of a type provided by both solicitors and accountants and may be subject to conflicting regulation. Furthermore, the application of the regulatory framework to all services including business and personal advisory services which are not reserved business and may be carried out without regulation by any other firm may lead to potentially anti-competitive practices by artificially pushing up costs as result of unnecessary regulation, thus encouraging consumers to seek services from unregulated providers.

This is not to say that regulation should only apply to the provision of services which are within the definition of "reserved business" but we would wish to highlight that there has to be a clear (and fair) demarcation of which services are regulated and which are not. It is important to consider not only competition as between "traditional" law firms and ABS but also between other traditional professional firms, non-regulated entities and ABS and, indeed, different types of ABS.

We note that the SRA has suggested that a "fit and proper" test should be adapted for external owners and has referred to other regulators having tests which may be of use. We would like to see an analysis of what tests are currently in use and how they function in practice in order to assess whether we agree with this statement. Similarly, we would request that the SRA provide further details of the existing models within other regulatory systems in respect of the "services" model of regulation.

We have reservations about the SRA's approach in that there is a differentiation between "investment" ABS, ie those with external owners of whatever type and "MDP" ABS – those with a collection of professionals offering different services.

This is, of course, entirely logical at first blush because in traditional law firms and "investment" ABS, the services offered are essentially the same. This is not so with MDP ABS. The problems arise when one considers that the rationale of the ABS regime is to remove barriers to competition and reduce cost to the consumer. When one considers that certain services will be regulated if provided by a traditional law firm or investment ABS, but will be unregulated (or differently regulated) if provided by an MDP ABS or by a non-regulated entity, it is clear that there is scope for criticism on grounds of competition law. There can be no logical reason for requiring a service to be regulated just because it happens to be provided by a solicitor, particularly where the solicitor is personally bound, in everything that he does professionally and socially, by Rule 1 of the Code of Conduct.

In our submission, the SRA should actively be consulting with other professional bodies and should create a list of professional bodies whose professional codes it accepts for the purposes of regulation of ABS. Likewise, there should be a list of professional bodies whose professional codes are not accepted. Where an ABS is to be licensed by the SRA, the entity itself will be subject to SRA regulation and each individual would then be subject either to the entire SRA regulatory framework (solicitors performing regulated services) or to their own approved professional rules for their own professional activities. Everyone else performing all other activities should be subject to the general duty in rule 1 and any other rules which are considered to be a mandatory minimum to ensure adequate protection for clients.

Section A: Reserved/non-reserved legal activities

8. We have considered many of these points in our response to (ix) above. We are in favour of maintaining the highest possible standards in all services provided through solicitors' firms however the approach set out by the SRA and the proposed maintenance of the separate business rule does present numerous practical difficulties, particularly if the suggestion is to apply the separate business rule to ABS. The effect would be a two tier system of regulation, favouring the "services" based model of MDP ABS in which solicitors could be part of a firm which carries out certain of its activities through in house personnel who are regulated less stringently or not regulated at all. This model negates the need for a second non-regulated entity for most purposes.

9. Those solicitors who remain in traditional practices would face a competitive disadvantage and market forces would dictate a move away from a position in which all services provided by solicitors are regulated to the same degree. It follows that the SRA may have to reconsider regulation of traditional law firms and not just ABS along the lines of the services model set out at paragraph A.2. If that were the case, the separate business rule would be essentially otiose. It is interesting to note that the Australian legal system, which has permitted MDPs and external ownership of law firms for a number of years appears to address legal regulation on the services model.

10. That said, we agree that the position set out in paragraph A.3 should be addressed as a matter of urgency. We would suggest that ABS structured in such a fashion should have a specific duty of disclosure to their clients covering:-

    - Any referral arrangements between the unregulated arm and the regulated arm;
    - The insurance arrangements for unregulated services;
    - The fact that the unregulated services are not regulated and what this means, particularly with respect to the right to complain to the Office for Legal Complaints; and
    - The client's right to instruct another firm.

11. We note that Australian law imposes a duty of disclosure on MDP firms (and incorporated practices) in a slightly different way and addresses a failure to disclose by requiring that the standard of care for any services provided where there has been non-disclosure should be the same as from a lawyer. It is not clear from the information we have whether this gives rise to a purely civil claim or can be translated into a conduct complaint giving rise to regulatory intervention.

12. We would respectfully disagree with the SRA on the issue of the separate business rule. We would suggest that the public interest would be better served by regulating all provision of legal services on the services basis, thus allowing solicitors to bring into the ABS any separate business which they may otherwise set up. Applying the overarching principles of Rule 1 to the entire structure should maintain consumer protection whilst minimising the pressure from market forces towards wholly unregulated entities. Any

practices using a separate business structure would be made subject to mandatory disclosure requirements and rules on referral arrangements.

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

13. We believe that there are certain organisations who should not be able to have any part in a firm providing legal services. These would include criminal organisations, or those with ties to organised crime or terrorism for obvious reasons. It would also include organisations such as the Consumers' Association trading company Which? Ltd on the basis that such organisations represent themselves as a wholly independent group providing only information services. As soon as such groups begin providing services commercially, or on the basis of self interest, there is a clear conflict of interest.

14. We must also mention the issue of confidentiality at this juncture. It is important that confidentiality and privilege continue to be respected by all involved in the provision of legal services. The extent to which outside owners are entitled to information concerning the identity of the clients of an ABS may in itself preclude certain people or organisations from becoming owners. Those who work for HMRC or police organisations, or even media organisations, for example, may be conflicted out of ownership of ABS if there is any possibility that they would become privy to confidential or privileged information adverse to the interests of clients.

15. Further details about what safeguards the SRA considers appropriate in respect of the information to which shareholders (or external investors) are entitled is necessary in order to consider this issue further.

16. One other potential group which may have an inherent conflict of interest is insurance companies. The rationale for our reservations about insurance companies is that insurers are frequently both defendants and funders of litigation. If, for example, an insurance company owned a firm doing claimant personal injury, there would be scope for a direct conflict of interest, as the insurance company may have a direct conflict with the clients of the firm. There could also be a potential competition issue inasmuch as insurers will often have to pay the costs of the claimant in successful personal injury claims and may have an interest in artificially inflating or reducing costs for their own commercial ends.

The former would improve profit margins of the ABS and give the insurers a greater return on their investment and the latter would reduce cost to the insurers in paying claims. In either event, the funds essentially flow in a circle which may carry the potential to distort the market as with the practice of cheque kiting.

C: Improving Access to Justice

17. We agree that access to justice for the purposes of the Act needs to be defined. In our submission, access to justice is not about driving down fees at all costs; it is about ensuring clear and proportionate costs, maintaining the highest standards of skill and care in giving legal advice and ensuring that solicitors' duty to the court is paramount. Access to justice should not be interpreted as access to a narrow range of legal services, particularly given the potential for inadvertent commission of offences, for example, in the field of company law and the increasing scope of regulation. Access to justice, if it is to be effective for the betterment of society as a whole, must necessarily include access to pre-emptive legal advice which may not fall within the narrow range of legal services specified.

18. We are at one with the SRA in the view that large commercial providers cannot be permitted to drive smaller practices out of business. It is however not appropriate to develop a protectionist regime to ensure the survival of practices which are not commercially viable – this would put client funds at risk and damage competition.

19. We think that the SRA are correct in suggesting that comments should be sought from the Office of Fair Trading and the LSB – we would suggest also the Competition Commission. As a general principle, we see no reason why the grant of an ABS licence cannot include, in appropriate instances, a requirement for a geographical impact assessment to be carried out where there is a risk that the ABS may have a detrimental effect on access to justice in any particular area. We note that the OFT already have procedures in place to refuse permission for mergers which may have an adverse impact on local competition see, for example, the decisions made in respect of the purchase of the *Safeways* supermarket chain.

20. As to taking into account the objective of improving access to justice, there is a perception that the main barrier to access to justice is cost. Whilst there may be some merit in suggesting that ABS competition will drive down cost, the real risk is that it is not only costs which will be cut, but also standards. Of course, it is fair to say that there is already a great deal of competition between solicitors' practices. In something of a "Catch-22" situation, the regulator must tread the fine line between ensuring that standards are maintained and not imposing too great a costs burden on those it regulates as costs will inevitably be passed on to clients.

21. We would suggest that access to justice could be improved by the SRA co-operating with the Law Society and other interested bodies to take positive steps to encourage firms to engage in pro-bono or fixed fee work, particularly for vulnerable members of the community. Although it would not be appropriate for the SRA to engage in offering any commercial benefit to encourage pro bono work, it may be possible for the SRA to be involved in a pro bono accreditation scheme or perhaps take pro bono work into consideration when setting licence fees or in calculating CPD requirements.

22. Of course, access to justice includes the guarantee that clients can discuss matters with their solicitor (or other legal advisor) frankly and openly to ensure that they obtain appropriate advice on their rights and obligations. It is our submission that maintaining access to justice must mean maintaining strong protection of both confidentiality and legal professional privilege.

D: Equality and Diversity Within The Legal Profession

23. We agree with the SRA's comments in relation to equality & diversity. In respect of the SRA's comments regarding networks of small firms, we would be interested to know what steps the SRA is contemplating to ensure that it is not open to one dishonest person to centralise client funds and misappropriate them as Mr Dixit Shah did.

E: The Fit and Proper Test for External Owners

24. We consider that it is appropriate to regard the FSA's model with a degree of caution given the widespread concern over the FSA's conduct of financial regulation. In

particular, we consider that there is an obvious risk in putting the onus on the individual to disclose relevant information. The experience of our members suggests that non disclosure, particularly in respect of financial or disciplinary matters and/or offences occurring overseas, is very difficult to identify and it may be some years later that the true facts come to light. If non disclosure is intentional for the purposes of perpetrating fraud, the fraud may be complete and the culprit vanished before the non disclosure is discovered.

25. We consider that a credit reference check and a CRB check would be appropriate in all instances. There are many sources of information for UK based individuals however we consider that there is a risk in simply accepting as "fit and proper" professionals from other jurisdictions or other professions. We would suggest that the SRA should enter into discussions with other regulators in other jurisdictions and of other professions with a view to establishing a regime for exchange of regulatory information. This would make it harder for people to withhold relevant information held in another jurisdiction and would enable the SRA to target investigative resources towards those applications from professions or jurisdictions which cannot or will not provide regulatory information.

26. Finally, we would consider that the duty of disclosure of matters relating to probity and financial soundness should rest on the external owner in the first instance but could be extended to senior fee earners and managers where they become aware of relevant information. Since we assume that ABS will be required to renew recognition annually, this is a question which could be included in the annual renewal request.

27. We would suggest that the fit and proper test should be generally the same for all external owners, subject to the de minimis 10% provided for in the Act. It would, of course, be wholly impracticable for all shareholders in a substantial plc to be subject to a fit and proper test. That said, the SRA should be in a position to ensure that a combination of natural and legal persons cannot escape the fit and proper test by structuring the ownership of an ABS between companies, LLPs and individuals so that on paper, all shareholding is less than 10%.

28. We agree that there is no reason in principle for external owners not to be permitted to own 100%, subject to appropriate safeguards.

F: Adverse Interests

29. There are, of course, some types of companies whose interests may, on occasion, be at variance with those of some types of client. Those that are immediately apparent are:

- Insurers
- Lenders
- Investigation Agencies such as private detectives
- Trade Unions
- Newspapers and Media
- Government Agencies

30. This list is not exhaustive and is premised on the concerns expressed in the SRA discussion paper and our concern that confidentiality of clients is paramount. Certain government agencies, the media and private investigators have an interest in obtaining and using information, it cannot be appropriate for them to obtain information by virtue of being an investor in an ABS which they would not otherwise be in a position to discover.

31. Appropriate safeguards could be full disclosure to clients of the relationship between owner and legal services provider, with an absolute bar on acting in the event of a direct conflict of interest and a rebuttable presumption that solicitors should not act in the event of a potential or generic conflict of interest. We would anticipate that the risk could be managed with relatively minor amendments to the conflict of interest rules.

G: The Role of Managers, HOLPs and HOFAs

32. On discussion with our members, it became evident that there would be a great deal of reluctance on the part of our members to take on the role of HOLP or HOFA should they ever become involved in an ABS. Whilst the issue may be of lesser importance where the majority of managers are solicitors, all subject to solicitors' standards of conduct, there is

a real concern that the HOLP or HOFA will be held responsible for the personal failings or dishonesty of those over whom he has no control. The concern would be particularly acute in an MDP where it is likely that other professionals would hold client monies and carry out services similar to those carried out by solicitors. This reinforces our concern that the demarcation between "legal services" for which, presumably the HOLP would be ultimately responsible, should be clear and unequivocal.

33. It would seem sensible that client accounts should continue to be separate so that, even as between say solicitors and accountants in an ABS, each profession should have its own client account. We do not believe it is appropriate for the protections contained within the Solicitors Accounts Rules and carefully developed over many years to be diluted and we cannot see that the maintenance of separate client accounts would be an excessive administrative burden. It would mean however that only authorised persons connected with the provision of legal services could access the solicitors' client account. In any event, reasonable segregation of client funds is likely to reduce risk inasmuch as, if one dishonest person does make off with client funds, less clients would be affected. We believe that experience teaches us that over centralisation of client funds increases risk and should be avoided.

34. Turning now to the discussion points raised by the SRA, we agree that there needs to be a degree of flexibility as to what qualifications are needed to be a HOLP or a HOFA. Given the very wide range of structures of ABS possible, it seems overly prescriptive to require a certain level of qualification. The HOLP and HOFA should be able to demonstrate that their integrity is beyond question; that they are aware of their responsibilities and have the knowledge and skills to perform them effectively. How this is to be demonstrated is an issue which will require further consideration.

35. As to whether traditional law firms and LDPs should be required to nominate a HOLP and a HOFA, we consider that such a requirement is otiose given the personal liability attaching to all partners in any event. The rationale for requiring ABS to appoint a HOLP and HOFA is to ensure that accountability rests with a designated individual. We would consider that requiring traditional law firms to appoint HOLPs and HOFAs would be the first step towards abandoning partner responsibility and would reduce protection for clients rather than enhance it.

H: Multidisciplinary Practices (MDPs): Different Service Combinations

36. We do not think that there is any need for a general restriction on service combinations. Legal services are many and varied and it cannot be said that, for example, a residential conveyancing practice would have any inherent conflict if it associated with an auditing practice on a limited basis. The position may be different if a commercial practice merged with an auditing practice but this could be addressed on a case by case basis. It seems to us that there will always be specific suggestions for service combinations which may be objectionable on one ground or another however the requirement for each ABS to be licensed (and, presumably, to renew its license annually) will enable the licensing authority to assess whether a specific proposal should not be permitted.

I: Insurance Requirements

37. We have touched on the difficulties we envisage with insurance above.

38. In principle, the starting point for deciding whether or not ABS should be entitled to enter the Assigned Risks Pool ('ARP') is that there must be a level playing field between all types of legal services provider. Any other arrangement defeats the purpose of the Legal Services Act.

39. That starting point works both ways. ABS should not be at a disadvantage because they are barred from the ARP but they should not be able to gain advantage over traditional law firms or other service providers because they are able to enter the ARP when competitors are not. The question then, which must be addressed before determining whether the ARP should be extended to ABS, is in how far should non-legal services be covered? Is it appropriate for the ARP and its members to fund cover where commercial cover has been denied because of the involvement of other professions or the activities of non-lawyers in an ABS? Should there be a provision that the ARP applies only to legal services?

40. As noted above, there needs to be a clear demarcation of "legal services" in order that legal service providers, insurers and clients are in no doubt as to which services (or fee

earners) are covered for what purpose. The question of insurance requirements for MDP ABS is complex and will need substantial input from insurers' representatives and other professional regulators. A clear and unequivocal agreement must be reached so as to avoid lengthy and complex disputes about what is and is not covered. In many instances, there will be a clear demarcation between one type of service and another however it is easy to anticipate transactions which will involve various professionals at various times carrying out overlapping work. Clients may reasonably expect the entire transaction to be subject to the same indemnity provisions; indeed, professionals may reasonably assume that the transaction is subject to one set of indemnity provisions but insurers may not agree – particularly if the firm has more than one indemnity insurance provider.

41. It seems likely that different work types carried out by different professionals will be subject to differing minimum standards of indemnity insurance. Clients will need to be informed, in clear terms, of the insurance cover relating to their matter, particularly where the coverage is not what they might expect.

J: Compensation Fund Requirements

42. We agree that the compensation fund and minimum indemnity requirements are linked. It is important to ensure a level playing field for all providers of legal services and there can be no doubt that all firms providing legal services should be treated the same with respect to contributions to the fund.

43. It is not possible to provide concrete views on how the compensation fund should work until indemnity insurance concerns have been resolved. If it becomes clear that ABS generally, or any particular type of ABS poses a greater threat and is likely to generate more claims on the fund, it is only fair and appropriate that the greater risk should be borne by those generating the risk.

K: Clarity for the Consumer (Descriptions)

44. Noted and agreed.

L: Conflict Between Different Regulators

45. As noted above, this can only be addressed by a clear definition of legal services.

46. We believe that the SRA should be reviewing the conduct rules of other professions and collating a list of those which meet minimum requirements. It is, of course, appropriate to note that not all "professionals" are regulated professionals. Accountants, for instance can properly be described as such even if they are not regulated at all. Other "professions" have optional or cursory regulation and we believe that anyone not subject to an approved regulatory regime should fall under the umbrella jurisdiction of the entity regulator irrespective of their submission to an alternate but optional or inadequate alternate regulator.

M: Special and Low Risk Bodies

47. We generally agree with the SRA's comments on this point however we consider that the generation of a set of rules which will entitle certain bodies to modification may be overly prescriptive. Whilst time will tell, we would not advocate an overly prescriptive approach to reducing or waiving measures intended to ensure that clients' interests are protected.

N: Other Perceived Risks?

48. We note the SRA's comments on the potential effects of financial collapse. This is an obvious risk which will need to be carefully considered. It may be argued that an ABS is more capable than a traditional law firm of diversifying and possibly avoiding financial collapse by, for example, seeking additional external investment.

49. It may be appropriate for the SRA to consider what disclosure ABS firms need to make upon annual renewal. This could include details of dividends paid. Where the dividends do not tie in with the profits generated by the firm, the SRA should have early information of it and be able to act quickly to ensure that risks are minimised. We consider that the SRA should review the protections provided for in Company and Insolvency law concerning dividend payments, misfeasance and trading whilst insolvent.

50. Other matters which the SRA will need to consider and consult upon in due course are:-

- What happens if a HOLP or HOFA dies or becomes incapacitated unexpectedly? Can there be more than one HOLP or HOFA – is this a task which can be conducted by a HOLP or HOFA board?
- What duties will solicitor fee earners have to report misconduct by external owners, or other professionals?
- What information will external owners be entitled to, in particular with respect to the identity of clients?
- Will the SRA allow centralisation and outsourcing of administrative functions (or accounts functions) and how will such outsourcing be regulated?
- Will the SRA, or other approved regulator, provide model articles of association or similar, modifying the general application of elements of company law?
- What is the view of indemnity insurers?
- What will happen to the Solicitors' Accounts Rules; will they become optional?
- How will compliance be monitored in an ABS; will the SRA carry out joint investigations with other regulators?
- Is it necessary or desirable that ABS should pay for regulation on a different basis? If there are many professions working together, is there a risk that too much of the regulatory costs burden will fall on ABS?

City of Westminster & Holborn Law Society
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