E-Briefing Detailed Version
(Covering the period from 1-30 April 2010[1])

Current consultations

As has been widely publicised, the SRA is currently conducting a consultation on "Outcomes-focused regulation" (For details see http://www.sra.org.uk/sra/consultations.page . The deadline for submissions is 27th July 2010.)

The SRA's consultation paper states, *inter alia*:

> **Executive summary**
>
> The SRA is transforming its approach to regulation for the benefit of consumers. We recognise that significant reform of our traditional approach is necessary if we are to be a "fit for purpose" regulator fit for the new legal landscape brought in by the Legal Services Act 2007.
>
> In particular, we recognise that our current rule book is detailed and prescriptive. It tends to lead to the use of resources which could better be deployed on higher-risk areas and doesn't help us to get the best out of our relationship with the profession. Even in the current marketplace it becomes increasingly difficult for detailed rules to keep pace with change. This will be even more so with the liberalised legal landscape starting in October 2011. A rule book needs to be fit for purpose; our regulatory approach needs to be more effective, proportionate and targeted so we can consistently regulate a greater range of legal service providers with a targeted, risk-based approach.
>
> Consequently, the SRA will move to a system of outcomes-focused regulation (OFR) which will offer a better focus on making sure firms offer good standards of service to consumers; and good firms more flexibility in how they operate their businesses.
>
> This transformation will involve
> - changing the way the SRA delivers its regulatory objectives,
> - changing the relationship legal service providers have with the SRA, and
> - further development of SRA staff skills and competencies.
>
> How will we deliver OFR in practice? Our approach will include
> - working with firms to focus on acting in a principled manner to deliver good standards of service to clients, rather than compliance with detailed rules;
> - a sophisticated desk-based research and analysis capacity to assess potential risks to the regulatory outcomes and support the delivery of targeted proactive regulatory action;
> - an approach to authorisation that is risk and evidence based, making sure that legal services are delivered by principled and competent firms and individuals;
> - an approach to supervision which encourages firms and individuals to tackle the risks themselves, allowing us to concentrate on those who can't, or won't put things right;
> - an approach to enforcement which creates a credible deterrent and is effective, fair and proportionate; and
> - concentrating our resources on dealing with those firms who pose a serious risk to our regulatory objectives, such as protecting and promoting the interests of consumers.

[1] Except where indicated

We want to foster a flexible and innovative market for legal services, combining improved access to justice with assured standards. For that reason, our plans for OFR will be introduced at the same time as the framework permitting alternative business structures (ABSs) in October 2011.

Flexibility, not lower standards, is the keynote of the new regime. Firms will be able to show compliance in ways best suited to consumers and their businesses. The SRA will act flexibly in its regulatory dealings, improving effectiveness and efficiency.

The risk-based approach will focus on the things which really matter to consumers and legal service providers. OFR is not light-touch regulation, it is effective regulation. It turns the page to a new chapter in the relationship between consumers and the law.
The purpose of this document is to set out our approach to this transformation and seek your views to influence and shape our thinking.

....12. The responses to "Achieving the Right Outcomes" have reinforced our decision to pursue an OFR strategy, and have helped to inform the development of our new approach to regulation.

....16. We believe we can best achieve this goal through .. ..focus[sing] on the important regulatory outcomes that must be achieved, rather than the means of achieving them, allowing the providers of legal services the flexibility they need to compete and innovate, particularly in the new legal services environment…

… The purpose of this document is to set out our approach to this transformation and seek your views to influence and shape our thinking.

I. Introduction

1. The SRA is transforming its approach to regulation and how we relate to and work with providers of legal services. Against a background of significant and welcome modernisation of the legal framework for the delivery of legal services, we will deliver a risk-based approach to regulation, focused on supporting delivery by providers of legal services of good outcomes for consumers and the public interest.

2. In particular, we recognise that significant reform of our traditional approach is necessary if we are to be a "fit for purpose" regulator in the new legal landscape brought in by the Legal Services Act 2007.

Our current rule book is too detailed and prescriptive and doesn't help either the profession or ourselves to get the best regulatory outcomes or develop a relationship based on trust and confidence. It needs to support and not hinder innovation for the benefit of consumers and encourage a much stronger focus by firms and by us on the overall quality of legal services. Our regulatory approach needs to be more effective, proportionate and targeted. Historically, we have spent too much time dealing with low-level issues, making it harder to focus on what is really important. We need to significantly improve our capacity to identify and deal with high-risk issues.

16. We believe we can best achieve this goal through using our resources to
….focus on the important regulatory outcomes that must be achieved, rather than the means of achieving them, allowing the providers of legal services the flexibility they need to compete and innovate, particularly in the new legal services environment; and

....17. Our approach includes ensuring that the requirements on firms are more focused on acting in a principled manner to deliver desired outcomes, rather than compliance with over detailed rules. We will do this by lifting the binding regulatory requirements ("rules") to the level of principles, stating the clear outcomes to be achieved where possible;

…23. The SRA's successful move to OFR will require the majority of firms and individuals to take responsibility for identifying and managing the risk of not delivering the required

principles and outcomes, acting ethically and professionally, exercising judgement on how to deliver good outcomes and engaging positively with us when difficult issues emerge. Firms that can do this will then be allowed to get on with running their businesses, leaving us free to focus our resources on the small minority of firms and individuals that cannot or will not comply.

..24.. . Good firms and individuals will need to be confident that we will not seek "to catch them out", taking enforcement action either on reasonable decisions made in good faith or in respect of a firm or individual that has run into problems but shows the willingness and capability to work with us to put things right.

…30: The May consultation will include, amongst other things, the new Code of Conduct, the new licensing rules and changes to the accounts rules. There will still be "rules" in the Handbook (such as the Accounts Rules and the Licensing Rules). However our aim is to remove as much unnecessary detail and prescription as possible.

…31. In particular, a redrafted Code of Conduct is central to our implementation of OFR. It concentrates on providing positive "outcomes" which are standards of service that all involved in the provision of legal services will wish to deliver in order [to] benefit consumers of legal services and the public.

...32. The new Code of Conduct will set out the key principles and outcomes which must be achieved and the objective is to remove or rationalise much of the detail contained in the current Code. The core of the Accounts Rules is likely to remain much the same, reflecting our judgement of what is necessary to manage risks to client money. However, these are being re-drafted in a more outcomes-focused way and the guidance in these rules will not be mandatory—see Table 2 below by way of example.

…61. Finally, our intention is to move away from an annual renewal process for firms, to be replaced by a requirement for all authorised bodies to pay an annual fee and to provide an annual information report.

… 63…Where warranted through risk assessment we will undertake more intensive analysis of particular activities including a firm's approach to exercising judgement on how to deliver particular principles and outcomes. Firms will also be assessed on whether their systems produce good outcomes: simply having a system will not be sufficient.

… 99…Nevertheless, this type of transformation cannot happen instantly and stakeholders will experience an evolution to the new approach rather than a "Big Bang".

Table 6 below sets out the timetable of key milestones up until 6 October 2011.

Date	Action
April 2010 onwards	Engagement with the profession, consumers and other stakeholders
28 May 2010	Publish first consultation paper on the Handbook. [In this regard, paragraph 33 of the OFR consultation paper also states: “**Principles**, which will be mandatory, will govern all of the activities of firms and individuals and will apply across the entire Handbook. We will be consulting on the ten principles in May.”]
27 July 2010	Closing date for written responses to "Outcomes-focused regulation: Transforming the SRA's Regulation of Legal Services"
20 August 2010	First Handbook Consultation closes.

October 2010	Publish second consultation on the Handbook.
October 2010	Policy Statement on "Outcomes-focused regulation: Transforming the SRA's Regulation of Legal Services" with the timetable setting out the transition to OFR, the full cost-benefit analysis and equality impact assessment (the equality impact assessment is an ongoing piece of work taking pace alongside the development of outcomes-focused regulation—we will share with you our work at the key stages of development). [In this regard, paragraph 94 of the OFR consultation paper also states: "Delivering good risk-based cost-effective regulation that directs regulatory attention to the areas of greatest need will require us to develop strong, flexible mechanisms for the management and coordination of our resources. Over the next few months, we will be considering this and reporting back in October on how our structure, internal communications and approach to decision making will support a robust governance structure for the coordination of regulatory responses across the SRA; • appropriate delegation of and support for quality decision-making at all levels of the SRA; • OFR functions, including importantly risk assessment, that operate effectively and efficiently, supported by strong horizontal management; • a quality audit system and systems for internal validation that provides positive challenge to the way we function and the decisions we make; • our existing formal decision-making criteria will also be reviewed. "]
January 2011	Second Handbook consultation closes.
March/April 2011	Publication of final Handbook
June/July 2011	Anticipated designation as a Licensing Authority for ABSs
6 October 2011	First ABSs licensed and Implementation of new Handbook.

Recent submissions

1. Professional Representation

1.1 Professional Rules and Regulation Committee

The PR&RC recently responded to the Ministry of Justice consultation on "Disclosure of information by the Office for Legal Complaints and the Legal Services Board: Orders under sections 152(3)(g) and 168(3)(g) of the Legal Services Act 2007" (See http://www.justice.gov.uk/consultations/docs/olc-lsb-info-disclosure.pdf for the consultation and http://www.citysolicitors.org.uk/FileServer.aspx?oID=782&lID=0 for the response.)

As the consultation paper stated:

Executive summary

The Legal Services Act 2007 ("the 2007 Act") establishes the Legal Services Board ("LSB") as the new oversight regulator of the legal profession and the Office for Legal Complaints ("OLC") to handle consumer complaints about legal professionals. The OLC will replace the numerous bodies that currently handle complaints about different legal professionals. The LSB became operational on 1 January 2010 and it is anticipated that the OLC will become operational in late 2010.

Under the 2007 Act both the LSB and the OLC are prevented, in the first instance, from disclosing restricted information to other persons.

There are a number of exceptions to the presumption against disclosure, including where other legislation requires disclosure. In addition, the 2007 Act provides the Lord Chancellor with the power to make an order specifying further persons who exercise regulatory functions to whom the OLC or LSB will be able to disclose information.
This consultation document considers the persons that should be included in such orders and the purposes for which disclosure to these persons should be permitted.

Introduction

This paper sets out for consultation some proposals of persons that should be included in orders made under sections 152(3)(g) and 168(3)(g). It also invites further recommendations of who should be included in these orders.

…10. …communication between regulators is an important component of an efficient and effective regulatory landscape and it is important that the OLC, as the new complaints handling body, is not impeded from sharing relevant information, where necessary, with regulators outside of the legal services sector.

11. This consultation paper will assist in identifying all of the persons that should receive information as well as establishing the purposes for which the OLC will be able to disclose information to these persons. This will allow for an order to be made that will permit disclosure of information to take place within limited, defined circumstances where there may be a tangible benefit to another regulatory regime. It will also contribute to greater communication and efficiency across the regulatory framework in England and Wales.

The consultation paper considered the case for allowing disclosure of information by the OLC to certain organizations pursuant to an order under section 152(3)(g). (Section 152 allows some exceptions to be made to the statutory restriction imposed by section 151, and allows "restricted information" to be disclosed.) The relevant bodies mentioned were:

- Office of Fair Trading
- Financial Services Authority
- Legal Services Commission
- Judicial Appointments Commission
- Financial Reporting Council
- Claims Management Regulator
- Law Society of Scotland
- Scottish Legal Complaints Commission
- Law Society of Northern Ireland
- Office of the Immigration Services Commissioner
- Information Commissioner

The consultation paper also argued for allowing disclosure of certain information by the LSB to certain organizations pursuant to section 168(3)(g)). (Section 167 sets out a general restriction on the disclosure by the LSB of "restricted information" (information obtained by the LSB in the exercise of its functions), followed by a number of exceptions listed in section 168). The relevant bodies mentioned were:

- The Insolvency Service
- The Financial Reporting Council

The consultation paper also asked respondents to consider whether there were any other persons or bodies that they believed should also be included in section 152(3)(g) or section 168(3)(g) orders.

The paper stated that the next steps in the process would be that:

> ..Following consultation, we intend to publish our response, along with draft orders, by 16 July 2010. .. The intention is for the orders to be in force before the OLC becomes operational, which is anticipated for late 2010.

The PR&RC's submission dealt with the specific questions contained in the consultation paper, and stated generally that:

> 3. We have responded to the questions in the manner requested. However we have a general observation regarding disclosure of information by the OLC. That is that we believe that the Orders (or any operating procedures implemented under the Orders) should require a judgement to be made in each instance that disclosure is appropriate having in mind, inter alia, the rights of the subject of the complaint.
>
> 4. Dealing with a regulatory investigation can have a significant impact on the practice of a law firm and/or an individual practitioner. It is costly and time consuming (both in real terms and in terms of foregone business opportunities) to engage with a regulator and there is always an attendant risk that, even if the regulatory breach is not substantiated, the matter may attract the attention of the press or otherwise come into the public domain with negative consequences for the reputation and business of those involved. It may also be the case that a disclosure from the OLC to another regulator is not Freedom of Information Act neutral; that is to say that information which might otherwise have remained confidential may be liable to come into the public domain as a result of a disclosure being made.
>
> 5. It is an unfortunate fact that a considerable number of complaints made to the OLC will have no merit. They may be frivolous or vexatious, but it may just be the case that the person making the complaint is unhappy with the outcome of a particular circumstance and feels aggrieved, even if the lawyer is not deficient. Multiplying the costs and stresses associated with such a complaint by involving a second regulator is clearly substantially to the detriment of the subject of the complaint. We feel it is appropriate for the OLC to be required to perform at least some fact finding work and to come to a preliminary judgement regarding the merits of the complaint before any information is handed over.
>
> 6. Paragraphs 20 to 22 of the consultation discuss the circumstances in which disclosure might be made by the OLC to the Legal Services Commission. The proposition is that the LSC should receive information on complaints that are upheld about lawyers who receive public funding. The consultation argues that this is a proportionate and reasonable safeguard and we strongly agree. The proposal is not that *any* complaint that refers to a legal aid practitioner should be referred but rather that only those that are upheld ought to be. We think that this is a sensible approach, which balances the interests of all involved.
>
> 7. We would argue that similar consideration should be given to the other circumstances in which the OLC will disclose information. Of course, it may be argued that in some circumstances the facts will not substantiate a complaint to the OLC but they would, for example, substantiate one to the FSA as an alternative regulator. We accept that, but that should not absolve the OLC from being required to come to a determination that, for example, the facts as reported are at least *prima facie* accurate, before involving another regulator. Otherwise a natural consequence may be that the firm and practitioners concerned are put to the costly effort of repudiating the same erroneous allegations twice, to the benefit of nobody.

Also, in relation to Question 9:

> *Are there any regulators of legal services in other jurisdictions that you believe should be included in a section 152(3)(g) order? What information would these persons or bodies require and for what purpose?*

the PR&RC stated that:

> We do not believe that there is a requirement to include regulators of legal services in other jurisdictions within the section 152(3)(g) order because the protection of the interests of clients in other jurisdictions is not within the ambit of the 2007 Act.
>
> However, at a fundamental level, the ethical rules applying to legal professionals in different jurisdictions are similar. For example, most jurisdictions prohibit a legal professional from exploiting his or her fiduciary relationship with a client for personal advantage. It would certainly be in the interests of consumers in the UK for our regulators to be made aware when an allegation of breach of a fundamental rule of practice has been upheld against a dual qualified practitioner (who also practises in the UK). It follows that an appropriate protocol for information exchange between regulators with this goal in mind is desirable and the making of an order for these purposes should be supported. However in this case, because the 2007 Act would not oblige the OLC to pursue the interests of consumers outside the UK, we believe that the information exchange should only relate to complaints which have been finally upheld and not to investigations or other preliminary matters.

2. Specialist Committees

2.1 Company Law

The **Company Law Committee** responded to the Institute of Chartered Secretaries and Administrators (ICSA) Review consultation on the 'Higgs Guidance' (i.e. the Good Practice Suggestions from the Higgs Report[2], last reissued in 2006) (see http://www.icsa.org.uk/assets/files/pdfs/consultations/ICSA%20Review%20of%20the%20Higgs%20Guidance%20-%20first%20consultation.pdf for the consultation document and http://www.citysolicitors.org.uk/FileServer.aspx?oID=784&lID=0).

As the consultation paper stated:

> Background
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> In its Final Report on the 2009 review of the Combined Code (likely to be called the UK Corporate Governance Code – 'the Code'), the Financial Reporting Council explained that it had '...commissioned the Institute of Chartered Secretaries and Administrators (ICSA) to work with others on its behalf to update as necessary the good practice guidance from the 2003 Higgs Report ... in the light of the proposed changes to the Code and economic and other developments'. Elsewhere in the Final Report, the text makes clear that the commission refers to the 'Higgs Guidance' (Good Practice Suggestions from the Higgs Report), last reissued in 2006.

[2] The Review of the role and effectiveness of non-executive directors, report published 2003 (or the "Higgs review") was a report chaired by Derek Higgs on corporate governance commissioned by the UK government, published on 20 January 2003. It reviewed the role and effectiveness of non-executive directors and of the audit committee, aiming at improving and strengthening the existing Combined Code. See http://www.berr.gov.uk/files/file23012.pdf for the report.

As part of this remit, the FRC has asked ICSA to consider whether additional guidance should be given on a number of related issues raised in Sections A (Leadership) and B (Effectiveness) of the Code. Given the focus of these additional areas, and their link to the content of the Higgs Guidance, ICSA has entitled the consultation paper 'Improving board effectiveness' to assemble the various strands of advice under one of the principal themes of the Code review.

The FRC's intention is that the guidance should be consulted by boards when considering how to apply the relevant principles of the Code.

The CLLS response stated:

...the response has been prepared by a working party of the CLLS Company Law Committee.

The first of ICSA's two consultations comprises three questions to which we respond below:

1. DO YOU AGREE WITH THE PURPOSE OF THE GUIDANCE?

1.1 The aim of the Review is stated to be to offer guidance which, without being prescriptive, assists boards in understanding and implementing the purpose of the Code and, in so doing, delivers practical advice to boards on how they can apply the Code to enhance their effectiveness.

1.2 We agree [with] this approach. We particularly welcome the emphasis on non-prescriptive guidance, the giving of practical assistance, and the overriding focus on enhancing board effectiveness.

1.3 We believe the Higgs Guidance has, in its current form, been a useful resource for boards. Changes to that guidance should reflect amendments to the Code and, particularly, changes in emphasis made by the revised Code, in each case using jargon-free language.

We do not think it would be useful for the guidance to include new topics not covered by the Code.

2. DO YOU AGREE THAT THE ICSA PAPER HAS IDENTIFIED THE RIGHT AREAS WHERE THE EXISTING GUIDANCE COULD BE ENHANCED?

2.1 Section 1.1 of the ICSA paper says that: "The guidance will refer to ethical sensitivity, and the need for the board to take account of ethical issues in setting business strategy and the manner in which business is undertaken."

2.2 We do not think it would be useful for the guidance to offer advice on ethical issues, for the following reasons:

2.2.1 Neither the revised Code nor the FRC's Final Report refer to ethical concerns in this context.

2.2.2 We think the scope of the board's obligation to take ethical issues into account is uncertain as a matter of law and we doubt that it will be feasible to establish a consensus as to good practice (falling short of legal obligation) in this area. While it may be said that boards are directed to consider "ethical issues" by paragraphs (b), (c), (d) and (e) of section 172(1) of the Companies Act 2006[1], we do not think it would serve a useful purpose for the Higgs Guidance to overlay these statutory requirements with further advice.

2.2.3 Questions of ethics are often subjective and can potentially be controversial (for example, some view involvement with tobacco companies or the sale of weapons as

unethical). We do not think it would be helpful to put at risk the largely uncontroversial nature of the Higgs Guidance by including new material on ethical issues.

3. ARE THERE OTHER AREAS WHICH THE GUIDANCE SHOULD LOOK AT?

3.1 New Principle A4 of the revised Code refers to the unitary nature of the board. We believe it is important that the guidance should endorse the comments on the unitary nature of the board and the collective responsibility of directors for the actions and omissions of the board that were included in section 4 of the Higgs Guidance.

3.2 It would also be useful for the guidance to update the pre-appointment due diligence checklist for new board members, the induction checklist and the sample letter of non-executive director appointment.

3.3 We recognise ICSA's potential interest in board evaluation (noted in section 2.3 of the ICSA paper) but believe it would be helpful for the Review to include in the guidance the conclusions from the FRC's discussions with the providers of evaluation services which are referred to in paragraph 3.42 of the FRC's Final Report – namely, appropriate standards for the evaluation process and the management of potential conflicts of interest. Alternatively, those conclusions might appear in some other publically available document.

2.2 Regulatory Law

As mentioned in the March 2010 e-briefing, the Financial Law, Insolvency Law and Regulatory Law Committees all responded to the HMT consultation paper "Establishing resolution arrangements for investment banks". (A summary of the consultation paper was set out in the March e-briefing (http://www.citysolicitors.org.uk/FileServer.aspx?oID=779&lID=0). As mentioned in that document, copies of the following papers are available online:

- The consultation paper: http://www.hm-treasury.gov.uk/consult_investment_banks2.htm
- The Financial Law Committee's submission http://www.citysolicitors.org.uk/FileServer.aspx?oID=777&lID=0
- The Insolvency Law Committee's submission http://www.citysolicitors.org.uk/FileServer.aspx?oID=776&lID=0

The Regulatory Law Committee's response, which can now be accessed at http://www.citysolicitors.org.uk/FileServer.aspx?oID=781&lID=0, stated, inter alia, that:

> …In view of the expertise of (and having had the opportunity to read the responses of) the CLLS Insolvency Law Committee (the **"Insolvency Committee")** and the CLLS Financial Law Committee (the **"Financial Committee")** covering the matters raised in Chapters 2, 4, 5 and 8 of the Consultation Paper, our comments are primarily directed to the other sections of the Consultation Paper, although we have addressed issues raised in these chapters where we consider that these questions could have a significant impact on the regulatory analysis. Although the questions or chapters that we have not responded to raise important issues that could well affect how insolvent firms are dealt with, we consider that others (including the other committees of the CLLS) are better placed to respond.

The Committee's submission also responded to a number of questions in the consultation paper.

2.3 Revenue Law

The Revenue Law Committee recently responded to the HMT discussion on proposals for controlled foreign companies (CFC) reform. (See http://www.hm-treasury.gov.uk/d/cfc_discussiondoc_260110.pdf for the consultation document and http://www.citysolicitors.org.uk/FileServer.aspx?oID=786&lID=0 for the response.)

The consultation document stated, *inter alia*, that:

> Introduction
>
> **Background**
>
> 1.1 The Government is committed to making the UK an increasingly attractive place in which to invest and do business. Over recent years the Government has announced a number of reforms to modernise the corporation tax system. The taxation of foreign profits has been identified as a priority area for reform.
>
> 1.2 Foreign profits reform has been separated into two parts. The first part was introduced in Finance Act 2009 and included a wide-ranging exemption for foreign dividends repatriated to the UK. Dividend exemption represents a significant change to the taxation of foreign profits for corporate groups and has been welcomed by business. To support the exemption, a limited interest restriction measure (the worldwide debt cap) was also introduced.
>
> 1.3 Given the complexity and importance of the Controlled Foreign Company (CFC) rules, the Government recognised that it would take more time to ensure that any new rules meet the needs of both Government and business. The review of these rules was therefore separated from the 2009 package to form the second part of the reform.
>
> **Document aim**
>
> 1.4 Following extensive consultation with business, this document sets out proposals for a new CFC regime. It concentrates on the overall shape of the rules and specifically addresses how the two most difficult areas of money and intellectual property might be addressed.
>
> 1.5 This document is for discussion with business and other interested parties. The Government welcomes views on these proposals and encourages continued stakeholder engagement.
>
> 1.6 The Government aims to publish more detailed proposals and draft legislation for consultation later in 2010, and to legislate in Finance Bill 2011.
>
> **History**
>
> 1.7 The Financial Secretary reiterated the Government's commitment to reform the CFC rules at the 2008 Pre Budget Report by publishing an open letter on the future direction of travel for the taxation of foreign profits. The Government committed to move towards a more territorial approach to the taxation of UK groups - firstly by introducing an exemption for foreign dividends and secondly by committing to modernise the CFC rules.
>
> 1.8 The Government published a *Policy Principles Document* in July 2009 that outlined the policy drivers, objectives and principles to support the CFC reform. A copy of this document is included as Annex A. To achieve the policy objectives identified, the proposals in this document have in some areas, adopted a pragmatic approach to applying the underlying policy principles.

Box 1.A: Key points from *Policy Principles Document*

- There is a continuing need for CFC rules to protect the UK tax base from erosion through the artificial diversion of profits from the UK which is not countered through other measures.
- The new rules will be targeted on artificial diversion of UK profit and not on taxing profits that are genuinely earned in overseas subsidiaries.
- An essential part of adapting a more territorial approach to the new rules will be moving from the current default presumption that all activities that could have been undertaken in the UK would have been carried on here, had it not been for the tax advantages of the overseas location.
- UK ownership and control are the most suitable basis for bringing artificially diverted profits within the scope of the UK tax base. This recognises the benefit gained from the rights and protections that residence in a state offers, such as the broader legal framework, and offers the most appropriate mechanism for applying the rules.
- Reform should aim to modernise the CFC rules in a way to reflect modern business practice with an aim of enhancing UK competitiveness, while providing adequate protection of the UK tax base.
- The new regime should, as far as possible, minimise compliance costs and seek to provide taxpayers with certainty. To achieve this a balance will need to be struck between the overarching principles and operational simplicity.
- The new regime is not intended to increase the scope of the current CFC rules and any new regime must be compliant with EU law

1.9 Consultation to date has demonstrated that it is difficult to articulate an all purpose definition of artificial diversion that is capable of practical application to cover all situations that the Government has been asked to consider. The alternative approach taken in this document has been to identify specific arrangements an transactions that the Government considers may provide opportunities for artificial diversion.

The Committee's submission stated, *inter alia*, that:

General

Overall, we consider that the latest proposals represent an improvement on previous proposals. We welcome the Government's approach of facilitating an open and transparent consultation with a sensible timetable for implementing any changes so as to enable full and proper discussion with businesses and other stakeholders. CLLS was represented at the Stakeholder event on 23rd February 2010.

Our main concerns over the latest proposals can be summarised as follows:

(i) If fully adopted, the proposals may not ultimately fully adhere to the stated policy of only targeting the "artificial diversion of UK profit and not taxing profits that are genuinely earned in overseas subsidiaries".

We would draw attention in particular to paragraph 2.17 of the consultation document, which confirms the Government's policy decision to eliminate the former "default assumption" that all activities that it was commercially feasible to carry on in the UK would have been carried on there but for a fiscal motive. In our view, the acid test is to look at a situation where there is no commercial advantage or disadvantage either way as to whether the activity is carried on within or outside the UK, and the activity is carried on outside the UK (a "commercially equivalent case"). If the former assumption has truly been eliminated, then, in that situation, nothing further should be required to secure exemption. However, in the very next sentence after stating that the old

assumption has been eliminated, paragraph 2.17 indicates that, even (apparently) in this situation, exemption would still be subject to a "redesigned motive test", according to which it would be necessary to "demonstrate the non-tax related commercial rationale" for a specified transaction or for the role of the company concerned. There is a clear contradiction in terms [of] first saying that the old assumption has been eliminated, and then postulating that the above test would apply even (apparently) in a commercially equivalent case. In a commercially equivalent case, there may be a "diversion of profit from the United Kingdom", but that diversion is, by definition, not "artificial". In addition, a provision which applied to a "non-artificial" diversion of profits would, in our view, clearly contravene EU law (see further below).

(ii) The current proposals are more than likely to lead to a regime which will justify being referred to as complex and involve unwelcome compliance costs and therefore may not meet the stated objectives of achieving minimised compliance costs and certainty with the result of also not achieving the key policy of enhancing the competitiveness of UK.

(iii) We support the principle that there should be a single worldwide regime rather than different regimes for EU and elsewhere. It is therefore absolutely crucial that any reform should demonstrably comply with EU law, as read in the light of the Cadbury Schweppes case. Stability and certainty of the tax system - as needed by business and stated to be a policy objective of Government - are not served by the enactment of provisions in respect of which, at the least, there is a good argument that they run contrary to EU law. A good example would be the legislative response to the Marks & Spencer decision, which was widely (and, as it turned out, correctly) believed from the outset to be insufficient to address the EU issues, and so only promoted further uncertainty. We are not convinced that the proposals yet fully take on board the extremely limited potential scope for a CFC regime permitted by the Cadbury Schweppes decision. After all the time and effort put into the process by many parties, it would be a disastrous outcome to end up with a regime that immediately faced further challenge in the courts.

(iv) The UK has a well developed transfer pricing regime which is the main weapon against the artificial diversion of profits overseas. The World Wide Debt Cap ("WWDC") is now in force and, to an extent, addresses the issue of "fat capitalisation" of overseas subsidiaries. The CFC regime should not seek to address any of the perceived abuses which these regimes are in place to prevent. If nothing else, this is likely to lead to complexity and confusion: the interaction between the WWDC rules and the transfer pricing regime is problematic since in many circumstances the two measures target the same arrangements (in our view, this is the case notwithstanding paragraph 5(9) of Schedule 28AA, which specifically provides against double-counting between WWDC and transfer pricing, and gives transfer pricing priority).

Similarly the WWDC rules sit uneasily with other interest restrictions (in particular the late paid interest rules). We would urge most strongly that further overlap between anti-avoidance regimes, each of which counteracts the perceived avoidance in different ways, should be resisted. If the transfer pricing and WWDC rules are not working as intended, then that should be addressed directly by changing those regimes

In our view, any Government concerns over "fat capitalisation" should be dealt with comprehensively under the WWDC and kept entirely out of the CFC forum. This is the only certain way of forestalling overlaps and impingements as between the CFC and the WWDC rules. We would also make the point that it would be absurd, and self-defeating in policy terms, if

the CFC and the WWDC rules covered the same areas, but with different exemptions and definitions applying in each case.

(v) The proposals assume that there can be an artificial diversion of UK profit where a foreign subsidiary carrying on genuine activities abroad is financed with too much equity. We do not accept this. Whereas a company can have too much debt, in the sense that it has more debt than a third party would lend, it cannot have too much equity: investors do not, in our experience refuse to invest in equity because there is insufficient debt. Equity will carry an arms' length reward in the form of dividends and capital growth. If the real concern is that the UK should not be allowing deductions for the cost of financing equity in foreign subsidiaries yielding exempt dividends, as stated above, the CFC rules are not the right vehicle for addressing this concern.

Ultimately, our level of overall concern will depend on the final form of the legislation and we would welcome seeing proposed draft legislation at an earliest stage as possible in the timetable.

The submission also addressed some of the specific questions in the consultation paper.

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