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Dear Ms Hope

Regulating Alternative Business Structures

Legal Services Act: New forms of practice and regulation, Consultation paper 18

1. The City of London Law Society (***CLLS***) represents approximately 13,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

2. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response to the SRA's Consultation on regulating alternative business structures (***ABSs***) has been prepared by the CLLS's Professional Rules and Regulation Committee. The Committee is made up of a number of solicitors from twelve City of London firms who have specialist experience in the area of the regulation of the profession.

We have responded on issues raised in the Consultation paper by reference to the section of the paper in which they were raised.

Section 2 – Starting Principles for the regulation of ABSs

3. We agree with the starting principles set out by the SRA, namely that there is no need for the SRA to look to create additional restrictions for the purposes of regulating ABSs beyond those envisaged by the regulatory framework in the Legal Services Act 2007 (the ***Act***). We agree that the risks to consumers from ABSs are, at the most fundamental level, the same as those that arise in relation to traditional law firms. Although it may be necessary for the SRA to develop specific rules within the Code or as part of the licensing regime, we do not think that the advent of ABSs raises wider questions about the means by which sections of the profession should be regulated.

4. The paper asks whether the SRA should seek to provide a regulatory framework for ABSs as soon as is possible. There are a number of issues to consider here. On the one hand, the profession is not in a position to understand fully the ramifications of the introduction of ABSs (for example, on diversity in the profession as mentioned by the SRA on page 15). All things being equal, this would indicate that the SRA should give itself the time to study matters further before introducing a licensing regime.

5. However we understand there to be demand from parts of the profession (generally not including our membership) to be able to innovate in the provision of legal services by means of ABSs. ABSs may be an opportunity for firms to obtain external capital and to change their business models as a means to recover from a continuing and deep recession in the market for legal services. Moreover, as we have commented elsewhere, we do not think that it would be at all desirable for the Legal Services Board (***LSB***) to feel itself required to establish a front line licensing authority and related regulatory capacity. In our view regulation should be left to front line regulators wherever possible. Further, there would be significant costs associated with the LSB taking these steps, and to the extent that they were necessary because the SRA itself was not able to grant licences for a period, those costs might be passed through to solicitors. On balance, therefore, we believe that the SRA should have an objective of introducing the regulatory framework for ABSs as soon as is prudent.

6. In the context of introducing a framework for ABSs, we would also urge the SRA to look to find a way by which firms that wish to convert to ABS status could accept some third party investment under a transitional regime prior to the full ABS regime coming in to effect. Non solicitors are actively building legal services brands (for example the Co-op) and it is important, given the regulatory objective of promoting competition in the provision of services, that the profession is not put at a competitive disadvantage.

7. In answer to the last of the questions posed in Section 2, we agree that the ABSs regime should provide the same degree of consumer protection as the existing regulatory framework.

Section 3 – What is an ABS?

8. We agree that it is helpful to try to conceptualise how potential ABS business models could be grouped at a high level and that the three broad examples set out on page 10 are a good starting point. However we are less convinced of the value in trying to conceive of all of the ways in which businesses will 'mutate' under the new regime as in Appendix A. For example, Model 6 (partial private equity ownership) need not arise only in relation to a legal services firm; you could have a combination of Model 6 and Model 4 with a private equity firm owning a multi-disciplinary practice.

9. Given this level of complexity, our thoughts would be as follows:

(a) We agree with the SRA that the regulatory regime should focus on outcomes and supervision rather than attempting to identify and prohibit 'dangerous' business models at the outset.

(b) We would advocate a regulatory approach (in line with the approach suggested by the Smedley Review in relation to corporate law firms) involving principle based regulation and a high degree of interaction between the regulator and the regulated. If, through dialogue, specialist SRA staff could understand how ABS firms are operating and were in a position to foresee regulatory risks arising, that would be an

effective way of protecting consumers' interests whilst also facilitating innovation and competition.

(c) We think that it is very important that further thought be given to the distinction between reserved work and what consumers may regard as broader 'legal services'. In the second of the models identified by the SRA on page 10 (a ring-fenced legal services division owned by a high street store), one would have to question why that high street store would want to put all of its 'legal services' activities into a heavily regulated ABS. Would it not be much more likely that the store would consider which 'products' had to be sold on a regulated basis and which did not? Having completed that analysis, the store might set up a relatively small division that provides regulated services whilst having a much larger team, unregulated by the SRA, that provides 'advisory' services including will drafting, contract negotiation and so forth.

We think that the inadequacies of the definition of 'legal services' will be a far greater cause of regulatory complexity in the ABS era than theoretical conflicts between ABS investors and clients.

Section 4 – The SRA's Broad Approach to the Regulation of ABSs

10. We agree that the thoughts set out in Section 4 of the Consultation paper regarding the approach to the regulation of ABSs appear to be on the right track, but of course this section only looks at the issues at a very high level.

Section 5 – Issues Requiring Further Consideration

11. *Reserved/non-reserved legal services*. We have commented above on the distinction between reserved and non-reserved legal activities. We would agree with the points in paragraph A3 regarding the need to educate consumers on the extent to which services that they may associate with a solicitor may legitimately be provided by somebody who is not regulated as a legal professional. This is certainly an issue to be taken up with the LSB.

12. The SRA is clearly going to have to consider the scope of Rule 21 of the Code and, in all likelihood, extend it to regulate the conduct of solicitors when providing services in connection with businesses with which they have no direct involvement but which are under common ultimate ownership. There are examples of regulation applying to the connectedness of entities (for example, in relation to broadcasting and the media) that might prove helpful. It seems that the overall regulatory approach will not be to forestall the introduction of new business models. As such, the obvious regulatory solution would be to place requirements on the solicitor to ensure that the client is not misled or confused as to the basis on which he or she is receiving advice from more than one of the connected entities.

13. *Prohibitions on ownership.* The SRA says that it cannot think of any types of business that might be prevented on an *a priori* basis from owning an ABS (being in every other respect fit and proper). We would agree with that point of view. Further our general stance would be that it would not be desirable to stifle innovation by trying to formulate categories of businesses who should not be allowed to own an ABS. Better would be to use the 'fit and proper test' and, if necessary, to introduce licence restrictions or provisions in the Code of Conduct (and related guidance) to deal with points of concern.

14. *Access to Justice and Equality in Diversity within the Legal Profession*. The SRA raises concerns regarding the possible affects of the ABS regime on the objectives of

improving access to justice and extending equality and diversity within the legal profession. We think these points have merit. Although, obviously, they do not form part of our membership, we would have concerns if the effect of the introduction of the ABS regime was to reduce the viability of small practices on the high street or in rural areas. Further, as the SRA points out, these practices may employ a disproportionately large number of BME lawyers, and so a reduction in their viability would have a corresponding affect on the profession's diversity .

15. It is right to have these concerns but the issues are complex. Outside investment leading to more money for investment in technology may improve the range of legal services available online, making practical legal advice available to those who cannot conveniently visit a solicitor, and doing so at a reduced price. On the other hand a shift to online services may disadvantage the elderly. Likewise new business models may increase the ability of lawyers to work from home or remotely, thereby making it easier for mothers and fathers from all backgrounds to balance professional practice and parenthood.

16. Ultimately it is impossible to foresee all of the consequences of the introduction of ABSs at this stage, and it cannot be assumed that the negatives will outweigh the positives. We think that the suggestions in sub-sections C and D regarding impact assessments and market analysis are appropriate, but this may ultimately be an area where the LSB should take the lead. We would also reiterate the points made before, namely that we believe that a key to increasing diversity within the profession is to encourage those from non traditional backgrounds to target a legal career (and corresponding academic attainment) whilst in secondary education.

17. *Fit and proper test*. We agree that the approach of the FSA to establishing fit and proper criteria is a good starting point from which to develop a test for use with ABSs. We also agree that it is unlikely to be viable to develop a 'positive test' by which a candidate would have to demonstrate probity as opposed to the absence of negative behaviour. Instinctively we would think that the same test should be applied once for any level of ownership and that it would not be practical to have a subsequent 'gating' mechanism where there was a change in the level of ownership or control by a previously approved entity – such a mechanism could introduce uncertainty over the transferability of shares in ABSs and make them less attractive vehicles for investment. We hold this view on the basis that the Code and related guidance should operate to ensure solicitors' independence of action (when representing clients) from the investors in their business. This should be entrenched whatever the respective shareholdings or degree of control over the business.

18. *Adverse interests*. We do not believe that a robust example has been provided of a circumstance in which the likelihood of adverse interests is so high that a particular class should be prohibited from owning or participating in an ABS. We think that the issues associated with adverse interests could be resolved primarily by reference to the existing rules of practice (Rules 3 & 4 together with Rule 1).

19. However there may be circumstances in which it would be appropriate for an ABS to introduce certain structural controls (for example regarding the level of information provided to investors and the degree of control of investors over business acceptance). Likewise, there may also be circumstances where it would be appropriate for lawyers working in an ABS to have disclosure requirements regarding associated entities (in the same way that newspapers commonly identify their ownership when reporting on related entities), so as to ensure that consumers can make informed decisions.

20. *The Role of Managers, HOLP's and HOFA's*. We believe that the HOLP should be a practising solicitor. Given the complexity of the role, we would also suggest that the HOFA should be a qualified accountant. However it would be possible to think of circumstances in which other relevant experience could be deemed to be adequate in lieu of an accountancy qualification or where a lesser but relevant qualification might be appropriate.

21. We do not believe that there is any good reason to extend these statutory roles to 'traditional' law firms. These roles were introduced by Parliament as a response to the clear additional risks associated with ABS practice while traditional law firms have functioned perfectly adequately in the area of regulatory compliance to date. To extend these (potentially onerous) provisions to traditional law firms where there is no proven regulatory requirement seems likely to contravene the better regulation principles which the SRA has identified as being central to its regulatory strategy.

22. *Multidisciplinary practices (**MDPs**).* We agree that ABSs should not be limited to providing legal services: the MDP vision was part of the driving force behind the changes and has the potential to provide considerable benefits to consumers. We do not think that the issues identified should prevent the advent of MDPs. For example, it is not necessary to prevent accountants and lawyers from being in practice together; it would only be necessary to prevent such lawyers from providing legal services to audit clients (either at all or in certain circumstances). The large accountancy practices are already used to working on the basis of similar restrictions given the diversified nature of the services they offer.

23. *Insurance requirements*. We agree that the same levels of consumer protection should be offered to clients of ABSs as those of traditional law firms and that it follows that the compulsory insurance requirements should be the same. We would have concerns if ABS organisations could not purchase insurance in the market and would not necessarily advocate the creation of an assigned risks pool to deal with this issue. This situation may not be the same as where a 'traditional firm' has problems getting insurance due to its past claims history; rather, it might be indicative of a potential insurer's misgivings about the viability of a particular ABS business model or the risks associated with that model. In such circumstances we would not think that it necessarily follows that the risks should be underwritten by the profession in general. Rather, it might well be appropriate for that business to close.

24. In relation to compulsory insurance, again issues arise regarding what is or is not a legal service. Should the firm have SRA regulated cover for 'legal services' provided by non lawyers (e.g. tax planning services provided by an accountant who might be subject to separate regulation)? We would argue that with a 'model 3' ABS, insurance cover has to apply either to the whole of the entity or to individuals' activities (depending upon whether they individually submit to SRA regulation (i.e. they are on the roll or are a trainee)). It does not seem easy to us to find a dividing line on the basis of the type of services provided unless the ambiguities discussed elsewhere in this letter can be resolved.

25. *Special or low risk bodies*. We agree that it would be appropriate to regulate low risk bodies in the manner that LDPs are regulated at present. However the reciprocal should also apply. It is possible that the reason why there has not been as great a take up of LDPs as might have been imagined is because of the uncertainty associated with their regulation after the introduction of the ABS regime (in to which they will be subsumed). We think that the LDP concept is potentially attractive to a range of law firms that may wish to include a minority of non-solicitors (e.g. Finance Directors, Patent Attorneys) within the partnership but in all other respects to operate as a traditional law firm. The low-risk provisions give the SRA the means by which these businesses may operate without being subject to an unnecessary regulatory burden and we would strongly urge the SRA to take that approach.

26. *Other risks, financial collapse*. It may be the case that external interests will cause ABSs to be more financially unstable than traditional law firms because there will be a separation between the identity of the financiers of the business and that of the principal employees. This separation may encourage a short term outlook, particularly if the financiers are looking for an 'exit' from their investment. However it is just as likely that the introduction of external ownership will ensure that firms are better capitalised and better run than smaller firms are at present. Successful private equity firms, for example, will bring considerable management experience and are likely to insist on sound financial management and rigorous reporting to the Board. We understand the concerns raised by the SRA but this is an area which would require much further thought before any specific regulation is formulated. Capital adequacy requirements have been rightly rejected by the SRA and we would have concerns about the impact on the operation of the business of 'a duty of sound and prudential financial management'. What would this entail that is not already covered by Rule 5.01(1)?

Yours sincerely

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CLLS