

A Legal Services Board: Roles and Operationalising Issues
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This paper discusses options for establishing a Legal Services Board (LSB) on the lines of the Clementi Model B⁺ agency. It focuses on the following issues:

- The objectives, powers and functions of the LSB.
- Roles and Institutional Structures.
- Oversight in a B⁺ Model.
- Strategies for intervention.
- Low-cost Regulation and Competition.

Summary of Main Conclusions

1. The LSB should be given statutory objectives but not the FLRs (Para 1.1).
2. The LSB should work to three statutory objectives:
 - Maintaining confidence in the legal system and the rule of law.
 - Protecting and promoting the interests of users of legal services.
 - Ensuring that regulation is cost effective and promotes competition (para. 1.1)
3. There should be an LSB duty to issue a written statement expanding on its statutory objectives and stating how these will be achieved (para. 1.2).
4. It should be provided in law that day to day regulation will be delegated to FLRs (para. 1.3.1).
5. It should be provided that the LSB shall agree MoUs with the FLRs and that there be an informal process of dispute resolution involving a panel set-up by the Office of Fair Trading with a judge as a member (para. 1.3.1).
6. The LSB should have a reserve power to regulate service providers directly but only on the meeting of certain statutory conditions (paras. 1.3.2; 3.1.2).
7. LSB board members should be appointed by the Secretary of State (para. 2.2.1).
8. Representatives of FLRs should not be appointed as members of the LSB board (para. 2.2.1).
9. The LSB's fees and charges should be independently reviewed by a government agency to ensure cost-effective regulation (para. 2.2.1).
10. The LSB should produce Annual Reports, appear before Select Committees and be subject to the Ombudsman's Jurisdiction (para. 2.2.1).

11. The LSB should hold an annual public meeting (para. 2.2.2).
12. The LSB should be obliged to issue a public consultation document before producing statements of general, regulatory policy (para. 2.2).
13. The LSB should have to give regulatees reasonable notice, opportunities to act and access to consultation before taking enforcement actions (paras. 2.2; 3.6.1).
14. The LSB should have to consult FLRs before issuing general statements of policy (para. 2.2).
15. The LSB should have to accompany binding rules and directions with a statement of conformity with statutory objectives (para. 2.2.2).
16. The scope of the regulatory regime should be set out in statute and secondary legislation with the LSB investigating regulatory gaps and needs for change. The LSB should advise the Secretary of State on amending legislation (para. 3.3.1).
17. The LSB should not have a power to compel an FLR to regulate a particular activity or group of providers (para. 3.1.2).
18. The LSB should have powers to approve the FLRs as regulators of alternative business structures as well as any proposed arrangements for particular ABS packages (para. 3.1.3).
19. A system open to provider or service-based regulation should be retained under the control of the LSB (para. 3.1.4).
20. Criteria for LSB approval of FLRs should be set out in statute and expanded by the LSB (para 3.2).
21. The LSB should have the power to approve FLR rules and amendments to these as well the power as to require rule changes (para. 3.3).
22. The LSB should have a general power to investigate that is less constrained than its power to regulate providers directly (para. 3.5).
23. The LSB should possess a full range of sanctions for potential use against FLRs or directly regulated providers (para. 3.3.6).
24. LSB sanctions should include powers to suspend licences, fine, adjust levies, name and shame and operate undertakings agreements (para. 3.6.2).
25. The LSB should be empowered to proceed against FLRs in disciplinary cases where there is undue leniency (para. 3.6.2).
26. LSB disciplinary decisions should be appealable to an independent body (para. 3.6.4).
27. The OLC should be separately staffed and branded but work towards objectives set by the LSB (para. 3.7.1).

28. The LSB should supervise the OLC on systemic and policy issues but not on individual complaints (para. 3.7.1).
29. The OLC chair should be appointed by the LSB with the concurrence of the judiciary and key stakeholders (para. 3.7.1).
30. The OLC should refer conduct cases to the FLRs and, in cases involving conduct issues, should have a discretion to delegate the whole complaint (both conduct and service aspects) to the FLR (para. 3.7.3).
31. A super-complaints process should allow designated bodies to complain to the LSB about failures in the market (para. 3.7.4).
32. The LSB should be equipped with powers and resources that allow it to base its enforcement decisions on risk analyses (para. 4.4.4).
33. The LSB should have a role in controlling the FLRs' costs (para. 5.1.1).
34. The LSB should develop and apply a system for measuring regulatory burdens at all levels of control within the regulatory regime (para. 5.1.1).
35. The FLRs should be called upon by the LSB to identify market failures and potential remedies and to notify the LSB regarding these so that the LSB can evaluate the regulatory issues involved and issue a strategy statement which the FLRs must apply (para. 5.1.2).
36. The LSB should have a general power to instruct the FLRs to investigate regulatory issues and report back to the LSB (para. 5.1.2).
37. The LSB should develop a system for measuring the effectiveness of the regulatory regime in realising the LSB's statutory objectives (para. 5.1.2.).
38. Where any FLR proposes to restrict access to any market it should be obliged to make a case to the LSB for doing so (para. 5.2.).

1. Objectives, Powers and Functions

1.1 Objectives

In discussing the LSB's objectives it will be assumed here that all regulatory powers will be vested directly in the LSB which will be empowered to delegate control functions to the front line regulators on terms and conditions set by the LSB. Such an arrangement makes it clear that the LSB, rather than the front line regulators (FLRs) is the locus of real power. This will arguably be conducive to an LSB that enjoys public confidence – more so than a regime in which regulatory powers are given to the front line regulators and the LSB is allocated supervisory powers over those bodies. The front line regulators can be expected to counter this contention by arguing that vesting powers in the LSB involves a loss of independence in the regime as a whole. As far as practical effect is concerned, the vesting issue is probably less important than the framework of powers and obligations that governs relationships between the LSB and the FLRs.

Should the front line regulators be given the same objectives as the LSB? The logic of giving regulatory powers directly to the LSB implies that this should not be the case. The LSB should have statutory powers and statutory objectives. The LSB will also have powers to delegate activities to the front line bodies who will be obliged to act in accordance with the requirement of the LSB and who will be subject to LSB discipline. Within such a structure, the LSB is governed by statute and the front line bodies are governed by LSB controls. To subject the front line bodies to statutory obligations in parallel with LSB directives would undermine LSB control and discipline. The front line bodies, if in dispute with the LSB, would be able to invoke their own statutory objectives and this would both weaken LSB control and create regulatory uncertainty. If, moreover, the FLRs were to publish statements of how they would further their statutory objectives, these statements would potentially clash with those statements issued by the LSB.

The Clementi Consultation Paper and Final Report suggested the use of six possible key objectives for a regulator of legal services. If it is accepted that a general aim of the LSB should be to produce good regulation, it is worth examining the Better Regulation Task Force's Five Principles of Good Regulation and using a formulation of the Clementi objectives that is consistent with those five principles of:

- Proportionality
- Accountability
- Consistency
- Transparency
- Targeting

It should be borne in mind in this exercise that it might not be advisable explicitly to demand furtherance of these principles in statutory objectives. Pursuit of good regulation might, on some issues be left as a policy matter, not a formal legal requirement.

The Clementi Report favours a short clear list of objectives – along the lines of those governing the Financial Services Authority (FSA). Such a list cannot constitute a detailed blueprint and inevitably has to be fleshed-out. Thus the FSA has four statutory objectives that can be summarised as:

- Maintaining confidence in the UK financial system.
- Promoting public understanding of the financial system.
- Securing the right degree of protection for consumers.
- Helping to reduce financial crime.

The FSA has, however, developed a risk-based approach to enforcement that gives central place to seven 'risks to objectives.' These seven risks are derived from the four statutory objectives and are: financial failure, misconduct or mismanagement, consumer understanding, fraud or dishonesty, market abuse, money laundering and market quality. (FSA, Building the New Regulator: Progress Report 2, London, Feb 2002).

In the case of the LSB, an issue is how such an expansion of statutory objectives is to be provided for. This is a matter to be returned to below.

As for the LSB's statutory objectives themselves, these might be set down in brief terms on the understanding that a fleshing-out process will be undertaken.

The three key objectives of the LSB might thus be stated as:

- Maintaining confidence in the English and Welsh legal system and the rule of law.
- Protecting and promoting the interests of users of legal services.
- Ensuring that regulation is cost effective and promotes competition.

1. Maintaining confidence in the English and Welsh legal system and the rule of law

This statement is analogous to the first FSA objective. It would take on board the Clementi Objective 1: ‘Maintaining the Rule of Law’ (which deals with equal treatment, fairness and human rights). It is consistent with the BRTF principles of accountability and consistency (fair implementation) and transparency.

2. Protecting and promoting the interests of users of legal services

This objective is analogous to the third FSA objective. It would cover the Clementi Objective 3 (‘Protection and promotion of consumer interests’) and also Clementi Objective 2 (‘Access to justice’) as well as Clementi Objective 6 (promoting public understanding of the citizen’s legal rights). These Clementi objectives can all be seen as part and parcel of protecting and promoting consumer interests. This objective would also cover the Bar Council’s suggestion to the Clementi Review that the regulator should seek to ensure that service providers are: a) suitably qualified and b) observe appropriate ethical standards. To this end, the LSB might be given the subsidiary objective of ensuring that the providers of legal services act in a manner that is consistent with the highest standards of professional conduct. The LSB should be given a power and obligation to issue rules (either directly or through delegation to front line bodies) to ensure adherence to certain professional principles and precepts – notably those set out in the Clementi Report (pp.21-22) – and calling on such providers to act:

- With independence with the interest of justice.
- With integrity towards clients, courts, lawyers and others.
- In the best interest of the client.
- With respect to client confidentiality.
- Without discrimination on grounds of gender, ethnic origin, or belief or opinions about the client.

These purposes for issuing rules might be set down in statute, but the LSB would be given a discretion to set out details in the rules that it makes itself or commissions from front line regulators.

3. Ensuring that regulation is cost-effective and promotes competition

This objective would demand that the LSB seeks to achieve its statutory objectives in a manner that imposes minimal overall costs on the state and consumers of legal services. It accordingly calls for the LSB to rely on competition and market forces, rather than regulation, to the maximum extent consistent with the achievement of mandated objectives. This objective is consistent with the BRTF principle of proportionality and its requirement of cost minimisation in regulation. It also adverts to the BRTF principle of targeting and its requirement that regulators should aim to achieve given objectives without creating unwanted side-effects or costs.

Clementi's Objective 3 was 'promotion of competition.' A question that arises is whether the LSB should have a positive duty to promote competition rather than a simple obligation to rely on competition rather than regulation when feasible. The balance of argument here seems to favour a statutory duty to promote competition. This would be consistent with a positive approach to minimalist regulation. The actions of the LSB will influence the development of the legal services market and minimalist regulation demands that such influence actively promotes competition as a control rather than regulation. A further reason for a positive duty is that the OFT's powers under the Competition Act 1998 maybe limited by the new framework of rules established with the LSB.

Any duty to promote competition will have to be made subject to the LSB's other obligations to maintain confidence in the U.K. legal system and to protect and promote the interests of users of legal services. The question whether the LSB should have concurrent powers with the Office of Fair Trading on competition issues will be returned to below in Section 5.

A further issue arises concerning Clementi Objective 5: 'Encouragement of a Confident, Strong and Effective Legal Profession.' It can be argued that it may not be necessary to state this as a separate objective because it is part and parcel of Objective 1 and since it is hard to see how the LSB could maintain confidence in the legal system without ensuring that there was a strong and effective profession. It might be added that it is doubtful whether Sir David Clementi would have intended that his fifth objective should be read as meaning that the LSB should go beyond a regulatory role and act to represent or promote the legal profession. Sir David, after all, advocated the separation of regulatory from representational/promotional functions for the FLRs (Clementi p.32) and consistency would demand that the LSB should not be asked to combine these two different kinds of function.

1.2 LSB Objectives: Issues of Detail

As noted above, a regulatory agency's objectives can be fleshed-out by statements that go beyond statutory provisions. The case for using short, general statutory objectives in combination with delegated powers to expand on those objectives is that, in contrast with detailed statutory provisions:

- The former arrangement is more flexible and easier to adjust (it requires secondary not primary legislation in order to effect change). It will cope more readily with changes in market business arrangements, provider profiles and so on.
- The former gives more control over developments to the secondary rule-maker – which could be the regulatory body, the LSB.
- The former can create structured opportunities for periodic consultation and discussion.
- The latter may prove not only rigid, but vulnerable to attack in the courts.

There are different ways to cater for the expansion of statutory objectives – notably:

- By statutory instrument/order drafted by a Minister, approved by Parliament and providing guidelines that are binding on the agency.

- By a statutory requirement that the agency makes a statement on the way it intends to pursue its objectives – which statements may or may not be subject to Parliamentary approval.
- By statutory silence on the matter and leaving it to the agency to state informally (or not to state) how it will pursue its objectives.

The case against statutory Ministerial policy guidance is that this may place policymaking regarding legal services regulation too close to the heart of government and that this may prejudice the independence of the regulatory regime. It might be argued, moreover, that such independence is especially to be valued in legal services where important issues between citizens and state may be involved.

The case for a statutory requirement that the LSB should state how it will go about its job and achieve its objectives is that this encourages transparency, consistency and predictability in a way that statutory silence would not. Agencies such as the Civil Aviation Authority are obliged to issue such statements and it can be contended that encouraging transparency is at least as important in legal service provision as it is regarding air services – since civil liberties are at issue as well as the usual consumer concerns.

In the case of an oversight regulator there may be an additional argument in favour of a statutory requirement to state objectives and strategies for achieving these since there is a special need for transparency and clarity when multiple layers of regulatory activity are involved in a sector. If the LSB is to oversee bodies such as the Law Society and the Bar Council it might be said that compelling the LSB to state its objectives, and strategies for achieving these, in some detail will help to establish clarity on the interface between the LSB and those bodies and to encourage consistency of approach.

Stipulating the nature of such an obligation in a parent statute, moreover, provides an opportunity for laying down in law the procedures to be adopted by the LSB. Thus it might be provided by statute that consultations with listed stakeholders and other relevant organisations/parties must be carried out by the LSB before it issues such a statement of objectives and strategies.

1.3 Powers and functions

The powers and functions of the LSB are clearly linked to its objectives and to the regulatory strategies that it should adopt. It is in setting the boundaries of the LSB's powers and functions that the balance between the LSB and the professions is set. If the LSB has too few powers, it will not be able to act effectively to pursue its objectives and to control risks to the achieving of its objectives. If its powers are too great and, in addition, are over-used, the benefits of professional self-regulation may be endangered.

1.3.1 The Memorandum of Understanding

A danger in any regulatory oversight mechanism is that the oversight body engages in second-guessing of the FLRs and operates in an over-intrusive manner. The statute establishing the LSB should make it clear that day today regulation is to be delegated to the FLRs but a statute can only go so far in designated areas of responsibility and creating a framework for working relationships.

The Memorandum of Understanding (MoU) is a device commonly used to clarify regulatory responsibilities reduce bureaucratic frictions and to facilitate low cost regulatory coordination. The statute setting up the LSB should provide that the LSB shall agree MoU with all of the FLRs in order to lay down working arrangements. The advantage of an MoU lies in its informality.

In a regime in which the LSB possesses all of the regulatory powers, there are dangers, however, that the FLRs will be ill-placed to negotiate MoU that ensure that they are subject to light-touch regulation by the LSB. It is natural that disagreements will arise between FLRs and the LSB on the terms and application of the MoU. In order to deal with deadlocks there may be arguments for a process of ‘Referral for Comment’ to a panel set up by an independent body that is concerned to encourage competition and low cost regulation. This might be the Office of Fair Trading (OFT) and the panel should involve a member of the judiciary. Such a panel would comment on the disputed question and the matter would return to the LSB and FLR for resolution. This informal non-binding mechanism is likely to prove superior to any appeals or adjudicatory mechanism – or judicial review - insofar as it will operate more economically and quickly and it accepts that disagreements about matters in the MoU will inevitably have to be worked through by parties who need to sustain cooperative working relationships. The mechanism can be seen as a way to reduce the bureaucratic costs that arise from (inevitable) disputes rather than “another layer of government.”

1.3.2 LSB Powers Directly to Regulate Service Providers

It is assumed, as noted above, that regulatory powers will vest in the LSB and that the LSB will delegate control functions to the front line regulators (FLRs). In the normal course of events the FLRs will use their control powers under the oversight and with the guidance the LSB. Three options to be considered:

- a. Empowering the LSB to regulate service providers directly without their having to be a member of an FLR.*
- b. Allowing the LSB to ‘claw back’ particular regulatory functions from the FLRs with respect to all or any of the delegated functions.*
- c. Allowing the LSB to intervene with respect to an individual service providing member of an FLR in certain circumstances.*

On the first of the above options, we would allow this only on a reserve basis since it is inconsistent with the role of the FLRs as front line regulators (see Section 3.1.2 below).

Allowing the option (b) would permit the LSB to claw back part (or sometimes all) of the regulatory powers that have been delegated to the FLR. In such cases, the LSB would in effect take over the regulatory function of the FLR in so far as this is necessary to achieve statutory objectives.

The Clementi Review favoured allowing the LSB to retain a right to carry out regulatory functions directly. There may be a case for allowing this on a reserve or extraordinary basis but there are strong reasons for avoiding, in practice, LSB direct regulation of service providers, notably:

- Clawing back powers from FLRs would undermine the coherence of front line regulation and create regulatory confusion and uncertainty.
- Problems might be encountered in handing back powers to FLRs and in deciding when it was appropriate to do so.
- Where regulation is funded by levy there may be difficulties in adjusting charges to take account of claw backs.
- Claw backs would create fragmentations of accountability.
- Direct LSB regulation of service providers would involve the LSB in contentious areas and undermine its status as oversight regulator – especially if criticised for its own performance as direct regulator.

The effect of allowing option (c) would be to allow the LSB to intervene with respect to individual members only in certain circumstances. In exercising these powers, the LSB could be limited in various ways. It could be required to seek the prior approval of the Secretary of State. This process, however, could in practice prove very cumbersome, and would thus not be appropriate in circumstances where rapid action was required. It would also confuse the lines of accountability and would impair the independence of the LSB from government.

A preferable way to allow the LSB to act in a reserve capacity under the options (b) and (c) would be to allow it to regulate providers directly only when four legal conditions are satisfied, namely:

- That in the opinion of the LSB the FLR was failing to act.
- That action by the LSB was necessary to further the statutory objectives.
- That the FLR has been given reasonable opportunity and notice to act and is consulted before any action is taken.
- The LSB gives public justification for its actions.

The real key to avoiding either full-scale claw backs, and to limiting the extent to which the LSB would in practice have to intervene with respect to individual members of FLRs will however be found in giving the LSB sufficient powers to control, and if necessary to sanction, the FLRs. This matter is returned to in Sections 3 and 4. On LSB interventions regarding complaints see Section 3.7 below.

The functions of other regulatory bodies that oversee professional bodies both in the UK and overseas fall into five main areas:

- Approval/recognition of the professional body.
- Standard setting.
- Monitoring and investigation.

- Enforcement and disciplinary processes.
- Education and training.

Other, subsidiary functions include:

- Raising public awareness.
- Advising central Government.
- Participation in international fora.

The Clementi Report identified five core functions of regulation:

- Entry standards and training.
- Rule making.
- Monitoring and Enforcement.
- Complaints and Discipline.

How the LSB might carry out such functions is discussed in Section 3 below.

2. **Roles and Institutional Structures**

2.1 *The strengths of Model B⁺*

The Clementi Model B⁺ LSB gives responsibility for regulatory functions to the front line practitioner bodies but creates an LSB to provide “consistent oversight in respect of all the bodies.” The front line regulators would be required, under Model B⁺, to separate their regulatory functions from their representative functions.

The strengths of Model B⁺, according to Clementi are:

- Like Model A (the overarching body that takes regulation over from the front line practitioner bodies) Model B⁺ rationalises the oversight functions currently held by the Secretary of State, Master of the Rolls and others.
- Model B⁺ involves a single clear set of overall objectives.
- Leaving day to day rulemaking and oversight with the front line regulators increases practitioner commitment to high standards.
- Model B⁺ leaves front line regulatory powers with practitioners and this offers a higher level of independence from government than Model A.

- Model B⁺ offers the consistency of approach that Model A does since Model B⁺ allows the LSB to set minimum standards to which front-line regulators would need to adhere. (At the same time some scope for variety in provider rules would be catered for and this might enhance competition).
- Model B⁺ would allow the LSB to authorise new front line regulators.
- Model B⁺ avoids the organisational size of Model A and the potential unwieldiness.
- Disruption would be less in establishing Model B⁺ than Model A and risks of losing regulatory expertise would be less.
- Model B⁺ takes advantage of, and recognises the strong roots of, the professional bodies and their qualities of strength and independent mindedness as professions.

It was argued during consultations that Model B⁺ is likely to prove short-lived and that this will soon give way to a Model A super-regulator just as the oversight regime of the Securities and Investments Board gave way to the Model A Financial Services Authority (FSA) in the financial sector. It is worth, however, noting the factors that led to the FSA. These have been said¹ to have been:

- A blurring of product boundaries so that it became difficult to regulate according to the functions being carried out and so that the boundaries between regulators no longer reflected the economic realities of industry.
- A burgeoning of providers offering more and more services crossing product and sector boundaries.
- The growing need for a regulator to oversee financial conglomerates in the round - since these institutions dealt with risks that were not adequately addressed by any of the single regulators.
- The increasing necessity to address systemic risk.

Such developments are not replicated in the legal services sector where products tend to develop more slowly and where the systemic risk issue is not so pressing. The Clementi Report made the further point that in the legal services sector the 'big players' have a history of self-regulation and a strong tradition of independent regulation – both of which were absent in the financial services sector. Clementi argued, that, if starting from scratch and without a history of robust professional bodies, one might choose Model A 'for its clarity and flexibility' (p.36). It is critical, however, to get the institutional framework right to ensure an appropriate balance of powers and division of responsibilities between the LSB and the FLRs.

Model B⁺, according to Clementi, does build on established strengths and address weaknesses, but it has to be carefully implemented. A further argument in favour of Model B⁺ is that a move to Model A would leave the professional bodies to carry out a purely representative role and that this brings dangers: that the professional communities will

¹ See Briault, 'The Rationale for a Single National Financial Services Regulatory' (London: FSA Occasional Paper, See: 2 May 1999) and the follow up: FSA Occasional Paper Series 2, February 2002: R. Baldwin, M. Cave and K. Maleson, 'Regulating Legal Services: Time for the Big Bang?' (2004) 67 MLR 787-817.

become more self interested and less publicly minded in their orientation; and that professional commitments to codes of ethics will be weakened as the latter become replaced by new standards imposed by a regulator. It can be added that model B⁺ involves around a quarter of the transition costs of Model A (Ernst & Young Report 2005).

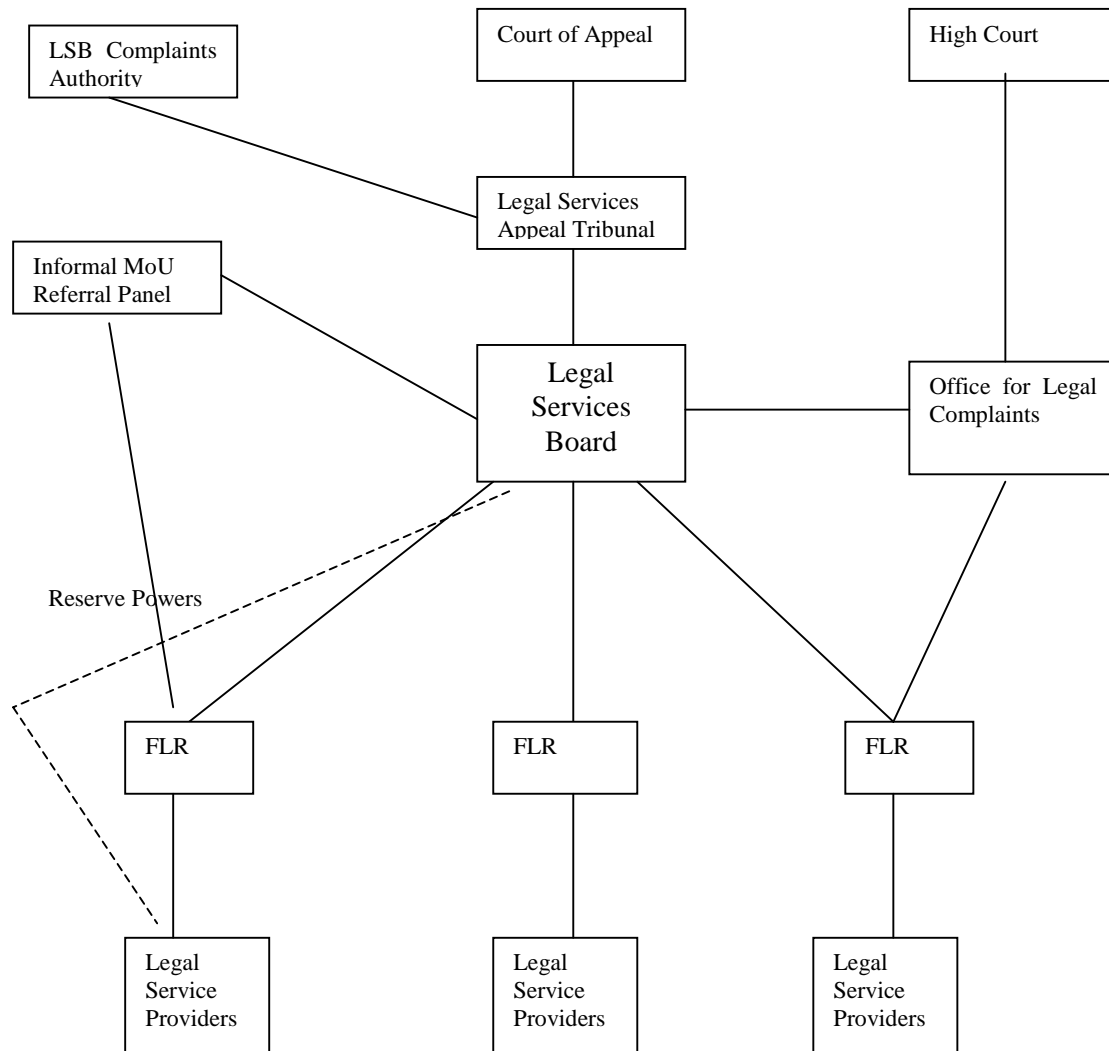
A challenge for a Model B⁺ agency will be to respond to changes in the marketplace and to new modes of providing legal services. The movement towards new business models is unlikely to be as dramatic in the legal as in the financial sector, but it would be undesirable if a choice of Model B⁺ rather than Model A were to impede either the market-driven development of new modes of service provision or the effective regulation of new services or new models of service provider. How a Model B⁺ agency might deal with these issues will be returned to in Section 3 below.

2.2 Options for Institutional Structure: Governance and Accountability

This section considers the governance and accountability options that exist together with their advantages and disadvantages. Examples of regulatory bodies in the UK and overseas are drawn on where relevant. A brief summary of the institutional structures of the key regulators of the professions and other self-regulatory bodies in the UK and overseas is given in Appendix 1.

Many issues relating to institutional structure will be discussed in this section, but it may be useful at this stage to offer a diagrammatic representation of a possible such structure.

Possible Institutional Structure



2.2.1 Governance structure

There are a number of key issues to be determined with respect to the governance structure:

- The appropriate balance between lay and professional representation on the LSB.
- Appointment of Board members.
- Whether the roles of chairman and chief executive should be split.
- The appropriate balance between executive and non-executive members of the Board.
- The role of non-executive members.
- Length of service on the board and conditions of appointment.
- Conformity to principles of good corporate governance.
- Funding.

2.2.1.1 *The appropriate balance between independent and professional representation on the LSB*

The LSB is intended to be an independent regulator overseeing the professional bodies' activities. However, the question remains whether the Board should be comprised entirely of independent members, entirely of representatives of the professional bodies, or some combination of the two.

There are several options:

a. Entirely independent members on the Board

This would enhance the independent operation of the Board, and as such reassure the public that the Board will be truly an independent overseer of the professions. However, it produces the disadvantage that it may reduce the credibility and legitimacy of the Board in the eyes of the regulated professions. A response to such concerns might be to appoint some members with relevant professional experience and qualifications but to have them act in a personal, not a representational, capacity.

b. Entirely independent members on the Board, supported by an executive Council which comprises representatives from the professions.

This is the model adopted in the accountancy field. The UK Financial Reporting Council (FRC) oversees professional regulatory bodies in that sector and possesses a three tier structure. The Board, consisting of 5 directors appointed by the Secretary of State for Trade and Industry, oversees the Council. The Council has 30 members including the five Board members, the chairs of the operating bodies and the Chief Executive. Its membership includes representatives from the business, investor and professional communities. It also has four observers from bodies with an interest in the FRC's work (currently the Audit Commission,

Bank of England, ICEAW and HM Treasury). The Board and Council oversee the five Operating Bodies, which are responsible for different area of regulatory activity, and are in receipt of powers directly from the Secretary of State.

Such an arrangement brings the advantage that the professional bodies can be involved in decision making at a high level, increasing the expertise and responsiveness of the Board to the professions, whilst balancing that with lay representation. However, the two tier structure may be considered too cumbersome relative to the LSB's functions and role.

c. A Board which balances independent and professional representation

This arrangement may involve either a majority of independent members or a majority of professional members.

In most cases where there are both professional and independent members, the majority are independent. This model is adopted by the Council for Healthcare Regulatory Excellence (CHRE) in the UK, which oversees the regulatory activities of the medical professional bodies. The Council has 19 members. Nine are representatives of the nine professional bodies which it oversees, usually the President or equivalent. Ten are independent members.

This model is also used by the Australian Financial Reporting Council, which oversees the professional accountancy bodies in Australia. The main governing body of the FRC includes members appointed from nominations put forward by key stakeholder groups, as well as members appointed independently of stakeholder interests. In addition, certain alternate members have been appointed to participate in FRC meetings when the members for whom they are appointed are unable to attend.

This is also the model adopted by the Legal Professional Advisory Council of New South Wales, Australia, which reviews the activities of the legal professional bodies in New South Wales. The Council has 11 members appointed by the Attorney General. Two are to be barristers, one of whom is selected from a panel of at least five people nominated by the Bar Council; three are to be solicitors, of whom two are to be selected from a panel of at least five people nominated by the Law Society; and the remainder are independent.

This model yields the advantage that the professional bodies can be involved in decision making at a high level in a single tier structure, increasing the expertise and responsiveness of the Board to the professions, whilst balancing that with independent representation. It would clearly enhance the independence of the Board if the majority of members were independent. Critics might argue, however, that the Board should contain no representatives from the professions because this involves a loss of independence from those professions.

d. A Board which is composed entirely of members of the professional bodies.

This has the advantage that it is likely to be accepted by the professional bodies, however it would not provide independence of oversight, and so is unlikely to command a good deal of public support.

2.2.1.2 *The method of appointment of Board members*

Again there are several options, and the decision links with that above on the issue of representation.

- a. *Chairman and Chief Executive (see 5 below) appointed by the Secretary of State for Constitutional Affairs; all or part of the remainder of the Board appointed by the Chair and Chief Executive***

In some other jurisdictions, the Attorney General is responsible for appointing the independent members of Boards. The Clementi Report, however, recommended that the different law officers should cease to be involved in oversight of the professions, and it may be desirable simply to give this role to the Secretary of State.

- b. *All Board members to be appointed by the Secretary of State. Chairman appointed by Secretary of State or elected by the Board from the Board membership.***

This is the usual model for appointing independent Board members of regulatory bodies. In some cases, for example the Office of Fair Trading (OFT) and the Office of Communications (Ofcom), the Secretary of State must first appoint a chairman, and then must appoint the remaining members in consultation with the chairman. This clearly has the advantage of ensuring that the chairman feels comfortable with the Board.

In the case of the CHRE, the Secretary of State appoints the first chairman, and thereafter the Council chooses its own chairman.

- c. *All independent members to be appointed by the Secretary of State; all representative members to be appointed from panels nominated by the professional bodies***

As noted above, combining independent and professional representation on the board of regulators overseeing professional bodies is the model adopted in the accountancy and medical professions in the UK, and by other professional oversight bodies overseas. Professional representatives could either be the heads of the different professional bodies (as on the CHRE), or be appointed from a panel nominated by the professional bodies (as in the Australian FRC and Legal Advisory Board of NSW). The latter option has the advantage that no one person is too overburdened (the heads of the professional bodies are already busy people), and of widening the pool of potential representatives from the professions. The disadvantage of allowing representatives of the FLRs to sit on the board of the LSB is, as noted, that this may be seen as detracting from the LSB's independence from the professions.

2.2.1.3 *Whether the roles of chairman and chief executive should be split*

Current best practice is to require that the roles of chairman and chief executive be split. The Combined Code on Corporate Governance and the Better Regulation Taskforce's report, *Independent Regulators*, both provide that the role should be split, and that if it is not, such a decision must be justified. (Although it may be noted that the Good Governance Standard for Public Services makes no recommendation either way on this issue).

Although the CHRE and the Financial Services Authority (FSA) are not subject to such a requirement, most of the recently established regulators, including OFCOM, the OFT and the proposed Charity Commission, are required to split the roles of chairman and chief executive, and the FSA has adopted this practice since 2003.

2.2.1.4 The appropriate balance between executive and non-executive members

Options

a. A majority of non-executive members

The Combined Code on Corporate Governance recommends that the majority of Board members be non-executives. The Better Regulation Taskforce has made the same recommendation in its report, *Independent Regulators*. Others, such as the Financial Services Authority, are required to have a majority of non-executives, and the governing statute gives specific functions to a non-executive committee (see below).

b. The balance of membership is left open for the LSB to determine

With respect to some regulatory bodies, for example the Office of Fair Trading, there is no statutory provision governing the balance between executive and non-executive members and the issue is left to the regulatory body itself.

The Good Governance Standard for Public Services makes no recommendation either way on the issue.

Overall, current best practice is to have a majority of non-executive members on the Board, and it is recommended that this is adopted either in statute or in practice by the LSB.

2.2.1.5 The role of non-executive members

Options

a. The role is stipulated in statute

b. The role is left open for LSB to determine in accordance with principles of good corporate governance

Statutes vary in whether they stipulate the presence of non-executive members of the Board and their role. They also vary as to whether the regulatory body has the power to determine its own committee structure, although it is usual to make provisions allowing for non-Board members to serve on committees and sub-committees.

In the case of the CHRE, the Secretary of State retains the power to make regulations determining the appointment, constitution and functions of committees and sub-committees of the Council.

The Financial Services Authority is required to establish a committee of non-executive Board members, the chairman of which committee is to be appointed by the Treasury. The non-executive committee is required to carry out a range of functions including:

- Keeping under review the question of whether the FSA is using its resources in an efficient and economic way.
- Determining whether it has adequate internal financial controls.
- Determining the remuneration of the Authority's governing body and its executive Members.
- Preparing a report on the discharge of its functions to be submitted to the Treasury with the FSA's annual report.

In contrast, the Office of Fair Trading and OFCOM have the power to determine their own committee structures.

Giving the LSB the power to determine its own committee structure would offer it the most flexibility to arrange its own internal procedures

2.2.1.6 Length of service on the Board and conditions of appointment

Options

a. The maximum tenure is set in statute

b. It is provided that Board members can only be removed for incapacity or misbehaviour

It is usual to provide for a maximum period of tenure of office, and to protect the independence of Board members by providing that they can only be removed for incapacity or misbehaviour. It is recommended that this practice is followed.

c. Whether Board members and staff are to be civil servants

Whether or not the Board members are civil servants and enjoy the privileges and immunities of the Crown varies considerably between regulatory bodies. In the case of the CHRE, for example, the Council is not regarded as a servant of the Crown and does not enjoy Crown immunities, but the Secretary of State determines the remuneration and conditions of appointment of Board members. In the case of OFCOM the Secretary of State determines the remuneration of the chairman and non-executive members, but not that of the executive members. The FSA, which is not in receipt of grants from Government, can determine the remuneration of all its board members.

In deciding whether or not the terms of appointment and remuneration of the Board should be a matter for the regulator or not, a key issue is usually the need to be free from civil service grade and salary levels in order to attract high quality staff. This may be necessary in the case of the LSB.

2.2.1.7 Compliance with the principles of good governance

Options

a. Whether a statutory provision should require the LSB to comply with the principles of good governance

The enabling statutes of most of those regulatory bodies that have been created in the last five years require them to observe the principles of good corporate governance. These are usually understood to be the principles set out in the Combined Code on Corporate Governance, and more recently, the Good Governance Standard for Public Services.

In addition, the Better Regulation Taskforce's report, *Independent Regulators*, recommended that all new regulatory bodies should be required to have regard to the principles of good governance and the BRTF's *Enforcement Concordat*. Including this requirement as a statutory objective may expand the grounds for legal challenge, however, and so it may be that following these principles is a matter best left to the policy decisions of the LSB.

2.2.1.8 Funding

The two other regulators of the professions, the FRC and the CHRE, have quite distinct funding structures. The CHRE is funded entirely by a grant in aid from the Government (£1.4 million in 2003/4). The Financial Reporting Council has a tripartite funding structure, and receives funding from the government, the regulated professions and the business community (listed companies).

There is of course no such parallel community with respect to legal services. The main options for the LSB therefore are:

a. Wholly government funded

This is the funding model for most of the independent regulators. The CHRE is funded entirely by a grant in aid from the Government (£1.4 million in 2003/4).

b. Funded wholly by the professions:

The FSA and the Civil Aviation Authority are two rare examples of regulatory bodies that receive no government funding. They are fully self-funded through a levy on regulated firms. As noted above, the FSA also has considerable autonomy in determining the remuneration and other conditions of service of its Board members.

Whether this option is suitable for the LSB is open to question. It has the potential to impose a substantial financial cost on the professional bodies and their members. As this cost would be passed on ultimately to the clients of legal services, it could be seen as detracting from the objective of protecting the interests of the users of legal services.

c. Part government funded, part funded by a levy on FLRs.

The levy could be linked to any risk based approach the LSB adopted (see further below).

This is the model used by the Environment Agency. It is part government funded, and also involves the imposition of fees and charges on those being regulated. Some of these charges are linked into the Agency's risk based framework: those posing the highest risk are subject to the highest charges (see below).

An advantage of part government funding (even if modest) is that the Government is seen to facilitate access to legal services. Another is that if the Government funds to the tune of a fixed fraction of costs (say a tenth) it will be obliged to monitor LSB expenditure in order to agree the exact monetary sum involved. That calculation can then be used to fix the quantum of the ninety percent of funding that is obtained through fees and charges. This will prevent the LSB from having an uncontrolled freedom to pass through costs to the professions and service providers. If that control function were to be exercised by the Treasury this might be seen as offering a higher level of protection for the LSBs independence than an arrangement in which the DCA carried out this function. (Mechanisms for setting regulatory spend are discussed below in Section 5.)

Even if the Government decides not to fund the LSB it is important that costs are controlled and that the LSB's fees and charges should be independently reviewed by a government agency to ensure cost-effective regulation. In order to protect the LSB's independence it might be appropriate to avoid giving the DCA this review function.

Table 1: Summary of Options for the Governance Structure of the Legal Services Board

This table sets out the key issues and options with respect to the governance structure of the LSB. It is intended purely as a guide to assist decision making. The numbering refers to the numbering in the text.

Governance issue	Yes	No	In certain circumstances
1. Board representation			
a. Entirely independent representation			
b. Independent board, supported by Council with professional members			
c.(i) Majority independent representation			
c.(ii) Majority professional representation			
d. Wholly professional representation			
2. Method of appointment of Board Members			
a. Chair and Chief Executive only appointed by Secretary of State			
b. Board members appointed by Secretary of State; chairman elected by Board members			
c. All independent members appointed by Secretary of State; all professional members appointed by SS from panels nominated by PBs			
3. Roles of Chairman and Chief Executive			
Roles split between two people			
4. Balance between executive and non-executive members			
a. Majority non-executive stipulated in statute			
b. Issue left open for LSB to determine			
5. Role of non-executive members			
a. Stipulated in statute			
b. Left for LSB to determine			
6. Length of service on Board and conditions of appointment			
a. Maximum tenure set			
b. Removal only for incapacity or misbehaviour			
c. Board and staff to be civil servants			
7. Compliance with principles of good governance			
Statutory requirement			
8. Funding			
a. Wholly government funded			
b. Wholly funded by the professions			
c. Part government funded, part funded by the professions			

2.2.2 Accountability

A fairly standard pattern of accountability structures is emerging with respect to regulatory bodies in the UK. Not all of the forms of accountability considered below apply to every regulatory body, but each one applies to at least one regulator.

Options

a. Annual Report to Parliament.

It would be appropriate for the LSB to produce such a report.

b. Select Committee oversight

The chair of the LSB would appear before parliamentary select committees and speak to all regulatory issues but not to the resolution of individual complaints or the day to day activities of the LSB (see Section 3.7.2 below).

c. Post-establishment, periodic reviews of operations by the sponsoring Department

Such a review is currently being conducted on the operations of the Financial Services Authority. Post-establishment reviews are also recommended in the Better Regulation Taskforce's report, *Independent Regulators* and in the BRTF report *Regulation – Less is More* (2005). The OECD's 'flagship report' of 2002 - *Regulatory Policies in OECD Countries* – also endorses the use of reviews as a tool of regulatory improvement. The values of reviews are, in addition, set out in the Mandelkern Report on Better Regulation (2002).

d. Sunset clause

This is a more radical provision than a post-establishment review. It has been the U.K's Government policy since 2000 that Regulatory Impact Assessments should consider the appropriateness of time limiting whole or parts of bodies of legislation.

e. Specific body to whom complaints about the activities of the LSB can be made by any interested person.

This may be in addition to any inclusion of the LSB in the jurisdiction of the Parliamentary Ombudsman, or act as an alternative to it. The body may be established in statute, or the LSB could be required by statute to establish one itself.

The FSA is required by statute to establish a system for complaints to be made about it, and it has established the FSA Complaints Scheme to serve this purpose. The advantage of a direct complaints scheme is that it involves a specialist body, and does not require complainants to go through the MP filter to reach the Parliamentary Ombudsman.

f. Jurisdiction of the Parliamentary Commissioner for Administration (Ombudsman).

There may still be value in providing that the LSB will be subject to the Ombudsman's jurisdiction, even if there is a separate complaints body, particularly if the complaints body cannot award compensation.

g. Consumer and/or Professional Practitioner Panels

These panels would advise the LSB on the performance of its functions and issue annual reports. It is important that they are adequately funded.

A statutory consumer panel is established to advise and comment on specified aspects of OFCOM's activities. In financial services, both a Practitioner Panel and a Consumer Panel advise and report on the FSA.

Whether or not either a consumer and/or professional practitioner panel is considered necessary or desirable depends in part on the level of consumer and/or professional representation on the Board of the LSB.

If neither consumers nor the professional bodies have specific representation on the Board, it may be desirable to establish panels for both.

If the professional bodies are represented on the Board of the LSB, it may be considered that a consumer panel could go some way to balancing that representation. As noted above, however, there may be a case for avoiding professional representation on the LSB board.

h. Annual public meeting

This is now considered best practice and all the recently established regulators (e.g. OFT, FSA, OFCOM) are required to hold an annual public meeting.

i. Appeals from disciplinary decisions of the LSB to an independent tribunal

This would ensure conformity to the ECHR. See Section 3.6.4 below.

j. Requirement to consult before exercising its powers to issue any principles, rules, directions or other orders requiring a professional body to act, or making any recommendations

It would be best practice to require the LSB to issue a public consultation document before it exercises any of its powers that do not relate to its enforcement and disciplinary activities. (When exercising its enforcement and disciplinary powers, it should be required to give notice to those affected before any actions are taken).

There may be a case for obliging the LSB to consult with particular organisations before policies are made or decisions are taken in certain areas. Thus, the Office of Fair Trading (OFT) might be consulted where competition issues are involved (See Section 5 below); the higher judiciary might be consulted where regulation will affect the operation of the courts; and any consumer advisory panel that may be established might be consulted when the LSB considered that a policy or decision has a material consequences for consumers.

A further issue is whether the LSB should be obliged to consult with the front line body before making a regulatory policy. Here it might be appropriate to limit this duty to the process whereby the LSB produces a general statement of objectives or periodic plan (see above, Section 1.2). On other issues it may be conducive to flexibility and efficiency to leave the issue of consultation to the LSB's discretion, having said that best practice will often

involve public consultations on policy and strategic matters. The professional bodies, in any event, will offer well organised and strong representation on a continuing basis and will necessarily have direct involvement in the regulatory process.

It might be appropriate to exempt the LSB from the need to consult in cases of urgency or where it has to regulate a service provider directly in order to further its statutory objectives.

k. Requirement to conduct a regulatory impact assessment before making any binding directions or issuing any binding rules

To the extent that the LSB has the power to issue binding rules and directions, it is currently best practice to require it to perform a regulatory impact assessment. Such an assessment is probably not necessary for recommendations issued by the LSB.

l. Requirement to issue a statement of compatibility with the statutory objectives.

To the extent that the LSB has the power to issue binding rules and directions, it is probably best practice to require it to issue a statement of the manner and extent to which the exercise of those powers conforms to the LSB's statutory objectives. Such a statement could extend to recommendations issued by the LSB.

Table 2: Accountability - Summary of Options

This table sets out a summary of the accountability options available for the LSB. It is intended to serve purely as a guide to decision making.

Form of accountability	Yes	No	In certain circumstances
a. Annual report to Parliament			
b. Select Committee oversight			
c. Post-establishment periodic reviews by Department			
d. Sunset clause			
e. Body to complain to about LSB with powers of redress			
f. Jurisdiction of Parliamentary Ombudsman			
g. Consumer and/or Practitioner Panels			
h. Annual public meeting			
i. Right of appeal of enforcement decisions to independent tribunal			
j. Requirement to consult before exercising powers			
k. Requirement to conduct RIAs			
l. Requirement to issue statement of compatibility with objectives			

3. LSB's Powers of Oversight and Intervention in a B⁺ Model

In an institutional framework that gives control powers to the LSB, but leaves front line regulators in place there are a number of ways to separate functions and to establish supervisory relationships. (As for practice with other oversight regulators, Appendix 1 offers brief descriptions of powers relating to a number of such regulators in the U.K and overseas). It may well be the case that the mode of supervision that best serves statutory objectives will vary across different regulatory functions and challenges.

This section looks at oversight options in relation to a series of functions – ranging from deciding the scope of regulation, to the approval of front line regulators, to disciplinary and complaints matters. The assumption, here, is that the LSB's regulatory powers will normally be delegated to the FLRs, and only in exceptional cases (see Section 1.3) would the LSB be able to act directly with respect to service providers.

The issues dealt with below are:

- The scope and targeting of regulation.
- The approval and recognition of FLRs.
- Rules and standards.
- Education and training.
- Monitoring and investigation.
- Enforcement and discipline.
- Complaints.
- Other powers and functions.

3.1 The Scope and Targeting of Regulation

A core challenge for any regulatory regime is to define which services, individuals or organisations are to be the subject of controls. The current legal services regime offers a mixture of service and provider-based controls, but has been criticised for its inflexibility. Under present arrangements activities can only be brought under regulatory control by primary legislation and this inhibits the protection of consumers when new forms of legal services emerge.

For the LSB key issues are:

- Who should determine the scope of the regulatory regime and how should this be set out?
- How can the institutional structure be best designed to ensure responsiveness to new issues and to enable it to address any gaps or inconsistencies in the regime's scope that may subsequently emerge?
- How should the regime be set up so as to cope with alternative business structures and new arrangements for providing combinations of legal and other services?
- Should the scope of regulation be determined with reference to services or providers or both?

3.1.1 *Determining the scope of regulation*

The Clementi Consultation Paper of 2004 and the Clementi Report argued that it was for the Government to decide which types of legal services should be regulated since these were questions of public policy. Even on this assumption, however, decisions have to be made about the role of the LSB in relation to such matters.

There are three main options for defining the scope of regulation:

a. The scope of the regime is set out in statute in detailed terms

Here the governing statute would set out the scope of the regulatory regime, either with reference to the types of activities to which it applies, or by reference to the regulatory bodies that are to be recognised.

The disadvantages of this approach are that it is very inflexible and does not create a dynamic regulatory regime which can protect consumers effectively by responding easily and quickly to changes in the market for the provision of legal services.

b. The scope of the regime is set out in statute and secondary legislation and is elaborated in Statutory Instrument, executive order or regulation. Provision is made for further guidance from the LSB on the meaning and application of these provisions

The LSB would have the day to day function of defining the scope of the regulatory regime within the parameters set by the governing statute and secondary legislation. The LSB would advise the Secretary of State on the need for secondary legislation to adjust the scope of the regime (see, further, section 3.1.2 below).

This model is used, for example, by the Financial Services and Markets Act 2000. The Act broadly provides that those carrying out a regulated activity need to obtain authorisation from the FSA. What constitutes a regulated activity is then defined in Statutory Instrument (the Regulated Activities Order 2001), which sets out the types of investments and activities which are covered by the Act. These provisions are interpreted and applied on a daily basis by the FSA when assessing applications for authorisation, or determining whether or not a person is carrying on unauthorised business. The FSA has provided some guidance on the application of the authorisation provisions.

The advantages of this model are that it allows for emerging gaps and inconsistencies to be addressed without amending the primary legislation whilst retaining yet it retains some Parliamentary involvement by employing statutory instruments with laying and approvals requirements.

Variations of this third model are used for the CHRE and the regulation of accountants and auditors.

In the case of the CHRE, the National Health Service Reform and Health Care Professions Act 2002 provides a list of bodies that are subject to the jurisdiction of the CHRE. This list may be amended in effect by the Secretary of State using his powers under the Health Act

1999 to recognise a new regulatory body for healthcare professionals. These powers are exercisable by Order in Council.

In the case of accountancy regulation, no person can act as an auditor of a company unless they are a member of a supervisory (i.e. professional) body recognised by the Secretary of State and have a recognised qualification. Under the Companies (Audit, Investigation and Community Enterprises) Act 2004 this power can be delegated to a new or existing body (i.e. FRC). The Secretary of State retains powers to recognise overseas qualifications. There are statutory criteria for recognition of a supervisory body, which can be supplemented by regulations made by the Secretary of State. The function of company auditor is statutorily defined.

In the health services and accountancy fields the governing statute defines the scope of the regime, though in the case of healthcare it does so by reference to specific professional bodies, and in the case of accountancy it does so by reference to types of activities. In both cases, some flexibility is provided by allowing changes in the scope of the legislation to be made by executive orders or regulations. Where, in such processes there is no parliamentary involvement in changes of scope, this may be seen as a disadvantage as compared to arrangements in financial services that involve statutory instruments that are subject to a positive laying which that involves approval by each House of Parliament.

The advantage of option (b) is that it provides some flexibility and the potential to respond quickly to changing circumstances. This is particularly the case if the statutory criteria are fairly general, and most of the detailed criteria for recognition are set out in secondary legislation. The regulatory body does have to ask the Secretary of State to pass secondary legislation in order to effect change, but it will advise on the content of the secondary legislation and if the Secretary of State agrees, changes can be made quite quickly.

c. Scope set out in statute in broad terms; no elaboration in any other delegated legislation or executive instrument

In effect this is the approach used for those bodies which regulate particular activities rather than certain sectors or providers. An examples is the Office of Fair Trading when applying its competition powers. The advantage is that it allocates broad discretions and confers significant flexibility on the agency, subject only to the normal processes of judicial control over interpretation of statutory powers.

This approach may not provide the degree of certainty, control and Parliamentary and executive oversight that is appropriate, however, for regimes of professional regulation, where it may be undesirable to allow unqualified persons to engage in certain activities and where it is appropriate to demand that a provider needs to be authorised before they can carry on the activity.

3.1.2 Responding to regulatory gaps

In option (a) above it is difficult to bring a new activity under regulatory control because primary legislation is required. Option (b) demands only secondary legislation and option (c) requires no further rulemaking. The Clementi Report favoured adjustment by secondary legislation and this raises the issue of the LSB's role. It is arguable that, even if ministers are to take final legislative decisions, it should be the oversight regulator, the LSB, rather than the

DCA that makes the initial assessment of the need to bring new activities within the regulatory regime. (The LSB can be expected to develop a closer knowledge of the market and consumer needs than the DCA as well as to offer a degree of independence from government). The LSB might fulfil its obligations to protect consumers through assessing the risks that are presented by new services and by making recommendations to the Secretary of State where the LSB judges that secondary legislation is required. (The risks here would be risks to the achievement of LSB objectives).

A set of further issues arises concerning newly problematic services and how these are responded to by a regime that relies on front line regulators to provide the direct regulation of legal service providers. It may be the case for, instance, that a new service is being offered by a set of unregulated providers; that the LSB estimates that there is a need for regulation to protect consumers; that the minister is happy to introduce secondary legislation to bring the services within regulation; but that no front line regulator is set up or willing to regulate the activity. In such circumstances the following questions arise:

a. Should the LSB have the power to regulate the activity directly?

It may be advisable to give the LSB a fallback power to regulate directly, but it would be undesirable to oblige the LSB to do this. Newly regulated activities are liable to involve high levels of contention and consumer dissatisfaction. LSB regulation of these would bring risks to the LSB's reputation and to its status as oversight regulator. Its authority with respect to the front line regulators would be weakened if its own system of direct regulation was to be subjected to public criticism.

b. Should the LSB have the power to compel a front line regulator to regulate a particular activity?

The LSB could be empowered to order, say, the Law Society to regulate the newly problematic activity. It might be argued that it is necessary to give the LSB a directive power because an existing front line regulator might be reluctant to expose its own members to new sources of competition by agreeing to regulate fresh entrants to a business sector. A danger here, however, is that a reluctant regulator is unlikely to prove the best guardian of consumer interests. It may be advisable, accordingly, not to give the LSB such a directive capacity.

c. Should those providing the new service have to find an existing FLR or set up their own FLR?

In the absence of a power to compel an existing FLR to regulate a new activity the effect of the secondary legislation bringing the new activity within regulatory control would be that persons or firms would not be permitted to carry out the specified activity unless they were regulated by a front line regulator that is approved by the LSB. Such service providers would then have to persuade an existing front line regulator to take them into its control regime (e.g. by offering attractive fees) or they would have to set up their own regulatory body and seek to have this recognised by the LSB. The Government would be free to assist and sponsor new regulatory systems, as occurred in the conveyancing field. The LSB would have the discretion to authorise interim arrangements under its fallback and general approval powers.

3.1.3 Coping with Alternative Business Structures (ABSs)

A particular set of regulatory challenges is presented when lawyers and non lawyers come together, as owners or as managers, to offer legal services (as in Legal Disciplinary Practices – LDP’s as proposed by Sir David Clementi) or to offer legal and non-legal services (as in Multi-Disciplinary Practices – MDPs).

This paper does not offer a position on the merits or de-merits of LDPs or MDPs. It is, however, concerned to discuss possible regulatory arrangements for controlling the provision, by lawyers and by others, of legal and non-legal services. (It is taken as given that the Government will encourage alternative business structures – as Lord Falconer has indicated in 2005).

It was made clear in the Clementi Report that alternative business structures (ABSs) can involve a number of quite different combinations of ownership, management and modes of service provision. They can give rise to a variety of tensions, control issues and possible conflicts of interest. Market responsiveness, may, nevertheless, call for a flexible approach to ABSs provided that this is consistent with the LSB’s objectives of maintaining confidence in the legal system, protecting consumers, providing low cost regulation and promoting competition. This suggests that the LSB should be given powers to approve both the front line regulators of ABSs and the arrangements that are made to regulate particular packages of services. An appropriate regime might possess the following characteristics:

- The LSB approves a front line regulator (FLR) as competent to regulate ABSs after assessing the FLR’s general arrangements and strategies for dealing with ABSs.
- The ABS provider applies to an FLR for a licence to provide a prescribed package of services through nominated individuals. The FLR, if satisfied with the arrangements set out by the ABS provider, seeks approval from the LSB to regulate the described package of services.
- On receiving LSB approval, the FLR grants to the ABS provider a licence to operate.

The case for such an *ad hoc* approvals mechanism is that the risks associated with different ABS proposals will vary according to particular circumstances, services, packages and organisational arrangements. It is accordingly advisable to avoid across the board requirements and to charge the LSB with the task of assessing the risks presented by any ABS proposal in the light of its statutory objectives. It would, accordingly, be up to the LSB to examine any proposed package; oversee such matters as the appropriate division of ownership or managerial control between lawyers and others; consider the suitability of arrangements for avoiding conflicts of interest; and rule on the acceptable level of external investment in the ABS and so on.

3.1.4 Whether to regulate services, providers or both

The Clementi Report noted that at present there is a mixture of provider and service based regulation. Solicitors, for instance, are regulated in everything that they do by virtue of their professional status. Some services are reserved and can only be offered by appropriately qualified persons (i.e. probate, immigration, conveyancing, notarial functions, rights to litigate, rights of audience). Some services, such as general legal advice, will drafting or

claims management are regulated if provided by a solicitor or barrister but may be unregulated if offered by other persons.

Consistency with the above discussion in Section 3.1 (and with Section 3.2 below) suggests that the LSB should be given:

- The power to approve front line regulators and their arrangements for controlling firms, individuals and services.
- The function of assessing whether a given service should be brought within the scope of regulation.
- The role of recommending to the Secretary of State that secondary legislation should be used to extend regulation to identified services.
- The task of determining in the first instance whether a service being offered comes within the scope of regulation.

We recommend, accordingly, that a system open to provider or service-based regulation should be retained but that this be placed under the control of the LSB.

3.2 Approval/recognition of the FLR

Central issues here are:

- The criteria for approval.
- Whether the criteria should be statutory, non-statutory or a combination of both.
- How detailed the criteria should be.

The options are:

a. Giving the LSB the power to formulate its own criteria for approval

An example is the OFT's powers to approve industry-based Codes of Practice. There are no statutory criteria, governing approvals rather the OFT has the power to devise its own. It has developed quite extensive and detailed criteria and guidance for Code sponsors on how to meet these criteria.

This option offers the advantage that the regulator is free to develop its own criteria in the light of its own knowledge and expertise. However, Parliament has little say in what those criteria should be.

b. Setting out broad criteria in the enabling statute which the LSB then develops in more detailed rules or guidance

This model is adopted for the Financial Services Authority. There are broad statutory criteria demanding that persons be 'fit and proper' before they are authorised to conduct regulated

activities. The FSA is under a statutory duty to publish more detailed guidance on the threshold criteria, which it has done.

This option brings the advantage that Parliament can stipulate the broad threshold but leave it to the regulator to develop more detailed criteria, which can then be developed in the light of experience and changing circumstances.

c. Setting out detailed criteria in statute or statutory instrument

This is the model adopted for the recognition of charities by the proposed Charity Commission.

This may be appropriate in the case of charities, given the other implications, particularly tax implications of charitable status. However, given that changing the criteria is a lengthy process, it has the disadvantage of introducing a high degree of rigidity and ossification into the system, particularly if the criteria are set out in statute.

d. Setting out in statute those existing bodies which the regulator is responsible for overseeing

This is the model adopted by the CHRE. The governing statute sets out a list of professional bodies which the CHRE is responsible for overseeing.

This may be appropriate where there is a currently identifiable set of professional bodies which regulators are to oversee. However, where it is anticipated that the landscape of professional regulation will be, or should be, a dynamic one, with new bodies developing or existing ones merging, this option would not be advisable.

The Clementi report envisages such a fluidity in the organisation of the legal profession, for example the recommendation that LDPs should be allowed to develop and the potential knock on effects on professional self-regulatory systems, as well as other issues relating to other groupings of legal practitioners, notably in conveyancing and immigration. This model would therefore not be a good model for the LSB to adopt.

The optimal course is probably to have a general provision in the statute setting out a broad criterion that the professional body be fit and proper and be able to carry out its functions effectively in furtherance of the LSB's statutory criteria. The LSB could then be under a statutory duty to develop and publish more detailed criteria.

It may be noted that approval/recognition powers are normally mandatory (a body has to obtain approval from the regulator) rather than advisory.

e. Should there be 'grandfathering' of existing professional bodies into the new regime?

A further issue regarding recognition is whether, on establishing the LSB, the existing front line regulators, together with their regulatory regimes, should be recognised automatically by the Board and 'grandfathered' into the regulatory system. Against such a proposal it can be argued, first, that a requirement that the FLR should gain LSB approval for its existing arrangements will offer the LSB a valuable opportunity to exercise quality control, and

second, such a requirement will allow the LSB to encourage coordination and consistency of approach across FLRs when this is appropriate; to fill regulatory gaps; and to eradicate unwanted anomalies, confusions and overlaps. On the other hand, a case can be made for grandfathering on the grounds that this reduces the transitional difficulties involved in establishing a new regulatory regime; it avoids the prospect of political disputes and deadlocks blighting the launch of the LSB; and, in any event, the LSB will, once established, be able to insist on any changes that it requires.

3.3 Rules and Standards

In the legal services field, as in other sectors, regulatory rules have to deal with such matters as entry standards, market conduct, ethical standards and disciplinary processes. The issues here are what powers, if any, the LSB should have to do any of the following:

- Issue rules, standards, principles or guidance documents which are binding on the FLRs.
- Approve rule changes of the FLRs.
- Recommend rule changes.
- Direct rule changes.
- Deal with rules which it considers might be anti-competitive.
- Address any problems of inconsistencies or gaps between the rules of the FLRs.

There is no consistent pattern discernible in the standard setting powers of the different regulatory bodies that oversee professional bodies. The FRC, through its operating boards, has quite extensive powers to set standards with which the professional bodies and its members have to comply. The CHRE has a general power to make recommendations, but in some cases can require changes to the rules, although only after they have been laid before Parliament. In its role as overseer of the regulatory activities of the recognised investment exchanges and clearing houses and of Lloyds, the FSA has the power to issue directions, including directions as to rule changes. The Securities and Investments Board initially had no power to direct the self regulatory organisations or to require them to comply with its rules. Subsequently, it was given the power to designate rules which would apply to the self regulatory organisations (the Core Rules). The Core Rules, together with SIB's Principles, in effect provided the overall framework for the rule books of the self regulating organisations.

Options

a. The LSB is given the power to issue rules/principles which are not binding on the FLRs

The advantage of this option is that the FLRs retain their autonomy and the strengths of profession-specific formulations of ethics are retained.

b. The LSB is given the power to issue rules/principles which are binding on the FLRs

The advantage of this option is that the LSB can provide a general framework for the development of rules by the FLRs. The disadvantages are that the rules issued may be too prescriptive, hampering the FLRs' abilities to determine the detail of their own rules and cutting down on the advantages of profession-specific formulation of ethical requirements.

The attractiveness of this option depends in part on what is decided with respect to the LSB's ability to require changes to the professional bodies' rules. If the LSB has power only to recommend changes, it may enhance its ability to achieve its objectives if it also has the power to issue some general principles to which the FLRs had to conform. However, there would have to be some sanction for non-conformity, otherwise the LSB's principles would be devoid of practical force.

c. The LSB is given the power to approve rules on recognition of the FLR and to approve subsequent rule changes

In this option the LSB would have the power to approve the rules of the front line regulators as part of the initial process of accrediting those bodies as recognised front line regulators. Thereafter the LSB would exercise oversight of the FLRs' rules through its role in approving changes to such rules and ensuring that they further the LSB's statutory objectives. This power is possessed by other regulators of professional bodies. A danger in an approvals mechanism is that this may reduce the speed with which an FLR can respond to a problem by changing a rule. Undue delay could be avoided by providing time limits. This could be done by means of a general stipulation that if the LSB fails to make a ruling on approval within a fixed time, the rules at issue will take effect. It may be advisable, accordingly, to impose a time limit on LSB approvals – either in delegated legislation or in the LSB/FLR MoU. The latter course of action would be the lower cost, more flexible option.

d. The LSB has the power to recommend changes to rules

A power of approval requires the FLR to take the initiative in changing its rules. In order to ensure that the LSB can fulfil its statutory objectives, it is likely to need at least the power to prompt the FLR to act.

The advantages of this option are that the FLR will retain the final decision making power over their rules and these bodies will be able to use established formulations of ethical and other rules.

The disadvantages of this option are that the LSB has no power to insist on rule changes and so will not be able to respond effectively to actions by the FLRs which are counter to the achievement of the LSB's statutory objectives.

In considering whether the LSB should have the power only to recommend rule changes or other actions by the professional bodies, some lessons can be learned from the experience of the Securities and Investments Board (SIB) under the regime established in 1986 for the regulation of financial services. The SIB had no powers to direct the self regulatory bodies to take any action or make any amendments to its rules. This severely hampered the SIB's ability to deal quickly and effectively with various issues, most notably pensions misselling. The Pensions Review, initiated by SIB, was finally agreed to by the SROs, but only after

much negotiation and ultimately litigation. Public and political expectations regarding the SIB's role were not matched by powers to enable it to meet those expectations.

e. The LSB has the power to require the FLRs to change their rules generally or in certain circumstances.

This power is clearly stronger than a power to make recommendations, and could be limited in several ways. For example, it could be restricted to the following:

- Rules that are judged to be anti-competitive by the LSB and/or the OFT.
- Rule changes that are needed to remedy inconsistencies in the rules of the professional bodies.
- Rule changes which, in the opinion of the LSB, are necessary to ensure the achievement of the statutory objectives/the protection of the public.

In each case, the power would be exercised only in consultation with the relevant professional body and the wider public.

The case for the third option, is that it would ensure that the LSB had sufficient powers to achieve its statutory objectives, whilst providing some assurance to the FLRs that its use would be circumscribed. (See also Section 5.1.2 on LSB powers relating to actions that are necessary to meet statutory objectives.)

f. Specific powers with respect to anti-competitive rules/practices

Provision for the rules of the FLRs to be reviewed on the grounds of anti-competitiveness and a general power to require FLRs to change their rules (option d(iii) above) would in effect provide the LSB with powers to require changes in anti-competitive rules. This is particularly so if the LSB was, as recommended in Section 1, given a statutory objective of promoting competition. Powers to require changes in anti-competitive rules are common in other jurisdictions. They have also been a feature of the regulatory regime for financial services in the UK since 1986. It is recommended that the LSB have similar powers with respect to anti-competitive rules or practices of the professional bodies.

The question arises as to who should determine whether the rules or practices in question were anti-competitive. The most obvious body is the OFT, acting either on its own initiative or on request from the LSB. If the OFT determined that they were anti-competitive, the LSB should have the power to direct the professional body to amend them accordingly. The balance between OFT and LSB responsibilities on competition matters is discussed further in Section 5 below.

3.4 Education and Training

As noted above, the other main area in which regulators of professional bodies may have a role is with respect to education and training. The key question concerns the LSB's role in setting standards for legal qualifications. Again, there are several options.

Options

a. Approval of FLRs' educational, training and professional qualifications as part of the initial approval process.

This would have the advantage of allowing the LSB to approve the educational and training requirements of any new body that applied to be recognised or approved by it, and of giving it a longstop power to act if those standards should fall seriously short (subject to the observation above that threats of licence revocation are rarely effective in this context). To the extent that the existing FLRs are 'grandfathered in' to the new regime, the power clearly would not operate initially; however it would be relevant for any new FLRs that seek authorisation from LSB.

b. Power to monitor FLRs' activities regarding education and training and to make recommendations.

This is the position of the CHRE. The advantage is that it leaves the issue of professional education and training in the hands of the professional bodies, which have a strong record in this area, whilst maintaining a general power of oversight.

To enhance the power, it could be provided that the recommendations be public, and the professional body would have to give a published justification for not accepting the recommendation. This would be akin to the status of the Combined Code on Corporate Governance.

c. Power to require FLRs to amend their provisions or other activities regarding educational, training and professional qualifications

This would enable the LSB to require FLRs to remedy what it considered to be any weaknesses, gaps or inconsistencies in this aspect of their work. It could be a valuable tool with respect to any newly emerging FLRs. On the other hand, there have as yet been no particular problems with this aspect of the activities of the more established professional bodies, this power maybe considered to be too great an intrusion on their roles.

3.5 Monitoring and Investigation

Regulators are generally required to monitor the activities of the professional bodies and their members, who are under a corresponding obligation to co-operate with the regulator.

The extent to which regulators are given specific powers to investigate the activities of professional bodies and their members varies considerably, however. The CHRE has a general power to investigate and report on how regulators carry out their work and, in certain circumstances, to investigate individuals. The Financial Reporting Review Panel monitors compliance of companies' financial statements with the reporting requirements. The Professional Oversight Board for Accountancy, in contrast, has no statutory powers to monitor the general regulatory activities of the professional bodies, but does so in co-operation with them.

Clearly, the greater the LSB's powers of monitoring and investigation, the more able it is to ensure that the professional bodies are acting in such a way as to further the statutory

objectives. However, any powers need to be balanced by appropriate procedural safeguards and MoU provisions.

One key issue is whether any powers of monitoring or investigation should extend to individual members of the professional bodies. The CHRE has the power to investigate individuals. The Accountancy Investigation and Discipline Board also has powers to investigate the conduct of members or member firms of the professional accountancy bodies and can take disciplinary action in public interest cases.

Options for LSB powers to monitor or investigate

- a. A general power of monitoring with a duty on FLRs (and individual members) to cooperate; no sanction for failure to do so***
- b. Powers to investigate FLRs (and individual members), including powers to request documents and electronically stored material and to interview persons, with sanctions attached for failure to provide material***
- c. Powers of entry, search and seizure regarding FLRs (and individual members), with or without a warrant***
- d. Powers to direct FLRs to undertake monitoring and investigative activities***
- e. Powers to recommend that FLRs undertake monitoring and investigative activities***

Any exercise by the LSB of its own powers of monitoring and investigation, or any exercise of its power to issue directions could be circumscribed by the condition(s) that, the LSB is of the opinion that the FLR must have failed to act, and/or LSB estimates that action is required in the public interest or to ensure the statutory objectives are met. This last provision would allow the LSB to investigate for the purposes of monitoring the regulatory activities of a front line regulator.

Giving the LSB the powers to investigate and proceed against individual members might seem to threaten the independence of the FLRs. FLRs would need to be consulted before exercising such powers. Care would also need to be taken to ensure there was no duplication of investigative activity and no possibility of double jeopardy for any individuals concerned (see the discussion in Section 3.6 below).

Giving the LSB the power to investigate FLRs and individual members would, however, enable the LSB to step in should it consider that the FLRs were failing in their responsibilities after due notice, and would potentially be more effective than simply issuing a direction for them to act. It would certainly prove more effective than a mere power to issue a series of recommendations that the FLRs take action. It may be advisable to limit the power to regulate directly by stating the grounds for this in statutory form and by demanding that the LSB should give reason for direct action – see Section 3.6 below. What may be appropriate is a general LSB power to investigate but a more circumscribed power to regulate directly and a set of broad powers to instruct FLRs to take such action as the LSB thinks appropriate for achieving its statutory objectives.

3.6 *Enforcement and Discipline*

The main issues on this front relate to the scope and application of the LSB's powers of enforcement and the sanctions the LSB should be able to impose.

In determining which sanctions the LSB should be able to impose, the recommendations of the recent Hampton Report on Inspection and Enforcement should be borne in mind. The Report recommended that regulatory bodies be given greater powers to impose a range of administrative sanctions on those they regulate than those which they currently have. There has been a more recent move to giving regulators greater powers to impose sanctions. In particular the OFT, the FSA and the Accountancy Investigation and Discipline Board each have the power to use a wide range of sanctions and other enforcement techniques.

Clearly, the extent to which the LSB should have powers to enforce and impose sanctions is dependent on whether or not it has been given the power to give directions or otherwise require the FLRs to act. If it simply has the power to make recommendations, it would be inappropriate to equip it with elaborate enforcement powers. It could still have some powers, though. For example, the CHRE, which in the main has the power only to make recommendations, has no direct enforcement powers as such. However, it does have the power to refer disciplinary decisions of the professional bodies to the High Court if it considers they are too lenient (see further below).

3.6.1 *Powers of LSB to discipline and sanction: scope and application*

There are two, interrelated questions on the scope and application of disciplinary and sanction powers.

- Whether the LSB should have enforcement and disciplinary powers over the FLRs only, including relying on the FLRs to enforce any rules or principles issued by the LSB which are directly binding on their members (if the LSB has such a rule making power).
- Whether it should be able to act directly against individual service providing members of those bodies in certain circumstances, and if so which circumstances.

If the LSB is given powers of enforcement and discipline only with respect to the FLRs this makes it clear that those bodies are to continue to be the front line regulators. The risk in such an arrangement is however that the LSB is then limited in its capacity to respond when an FLR fails, after due warnings to act against one of its members. This could compromise the LSB's ability to achieve its statutory objectives and dent public confidence in the regulatory regime as a whole.

Options

There are three main options:

- a. ***The LSB is given no powers of enforcement over individuals or individual firms; all powers lie with the FLRs***

- b. The LSB is given general powers of enforcement against individual members of FLRs in all circumstances***
- c. The LSB is given reserve powers of enforcement against individual members of FLRs in certain circumstances.***

It was argued in Section 1.3 that the LSB should have monitoring, investigation, enforcement and disciplinary powers over the individual members of FLRs and that it should have a reserve power to regulate directly but that use of these powers should be subject to certain statutory conditions.

Other overseers of professional bodies do have certain powers with respect to individual members of those professional bodies. The AIDB has the power to investigate and take enforcement action against individuals or individual firms in the public interest. This is considered to be an important power and one which is necessary to restore confidence in accounting and auditing practices in the face of well-publicised failings, such as Parmalat, WorldCom and Enron. There is no need for the AIDB to wait until the professional body has failed to act. The Irish Accounting and Auditing Standards Authority has similar powers.

The Canadian Public Accountability Board, which is a non-statutory body, also has powers to act against individual auditors or auditing firms.

The advantage of giving the LSB reserve powers to act to enforce both its own rules and those of the professional bodies would be that this would enable it to act in the last resort to ensure that its statutory objectives are met.

If the powers are given, the LSB should be required to give the FLR reasonable warnings and opportunities to act. It should also consult the relevant FLR(s) before taking action, as noted above (Section 1.3). The statutory provision that the FLR be unwilling or unable to act before the LSB could exercise its powers would avoid the problem of double jeopardy (both the FLR and the LSB taking enforcement action with respect to the same individual for the same breach). If such a statutory provision were not included as a general condition on the exercise of LSB's powers with respect to the FLRs, a separate provision should be made that the FLR does not also take enforcement action against the same individuals or firms, in order to protect against double jeopardy.

3.6.2 Sanctions and other enforcement techniques: Options

In considering the different options available, consideration maybe given to whether the sanction could apply to the FLR, and additionally whether it could apply to an individual member. For clarity, the following table indicates the target option it seeks merely to clarify the options, not to make recommendations.

Table 3: Options on the Potential Application of Sanctions

Sanction	Potential to Apply to FLR?	Potential to Apply to Individual Member?
Suspension/revocation of licence of professional body	Yes	No
Suspension/revocation of Licence of individual	No	Yes
Fines	Yes	Yes
Adjustment of fees or Levies	Yes	Yes
Waiver/repayment of Clients' fees	Yes	Yes
Compensation orders	Yes	Yes
Payment of costs of disciplinary processes/ verification processes	Yes	Yes
Public reprimand: 'naming and shaming'	Yes	Yes
Enforceable undertakings	Yes	Yes
Rights to proceed in cases of 'undue leniency'	Yes	
Private enforcement Options	Yes	Yes
Whistleblowing	Yes	n/a

a. Suspension/removal of the licence or approval of the FLR

It has traditionally been the case that the main sanctions of a licensing body have been the suspension or removal of a licence. To establish this as the only or main sanction is, however, not the optimal sanctioning structure that can be adopted.

This is particularly the case with respect to the licensing of a regulatory body. Removing the licence of an FLR will have extremely disruptive effects on its members' abilities to continue to practice, and in turn, on the provision of legal services. It is a sanction, accordingly, which is only rarely, if ever, going to be used, and both the LSB and the FLR will know this. It is thus, in practice, ineffective.

This is not to say that the power to remove or suspend a licence of an FLR should not be given to the LSB, it is simply to emphasise that the LSB will need a range of other sanctions as well if it is to be effective in achieving its statutory objectives. Note that this power to suspend or remove the approval in all respects of the FLR is distinct from any reserve power to 'clawback' regulatory functions from the FLR in certain circumstances.

b. Suspension/removal of the licence of an individual member

This may be a function better performed by the FLRs, subject to a requirement to report on such issues to the LSB and a power on the part of the LSB to refer cases of what it considers undue leniency to court or to a specialist legal appeals tribunal (see further below).

c. *Fines*

This power could apply both to FLRs and to individual members (to cover reserve LSB powers of direct regulation). There is an increasing move to giving regulatory bodies the powers to impose fines, and these can be a very effective enforcement tool. The maximum level of fine may be limited by statute (in the case of breaches of competition law, for example, the maximum fine is 10% of annual turnover), or it may be unlimited, as with the FSA and the AIDB.

Allowing for an unlimited fine clearly gives more flexibility to the LSB, but is a significant power. It should be balanced by ensuring there is a right of appeal to an independent tribunal (see below). It could also be balanced by requiring the LSB to issue a statement of policy setting out its policy on determining levels of fine. The FSA has a such a statutory duty with respect to its power to impose fines.

d. *Adjustment of fees or levies*

With respect to FLRs, giving the LSB the power to adjust fees or levies on an FLR that is not complying with any of its directions or other orders to take action can also be an effective tool. It can also be an integral part of a risk based approach to regulation. FLRs that have been disciplined by the LSB could be required to pay additional fees to cover the additional monitoring that they may be subjected to for the following year. This would be an extension of the practice currently used by the Environment Agency, and to an extent the FSA, whereby those firms which require more intensive monitoring, and thus investment of the regulator's resources, are required to pay higher fees.

It would probably not be appropriate to give the LSB this power over individual members, but rather to leave that in the hands of the relevant FLR.

e. *Waiver/ repayment of clients' fees*

This power would apply with respect to individual members.

In exercising its disciplinary powers to investigate individuals or individual firms in the public interest, the AIDB has the power to require member firms to waive or repay clients' fees. If it was considered that the LSB should have a similar power to investigate individuals or individual firms (see further below), then it would be appropriate for it to have the same power to require the waiver or repayment of clients' fees with respect to the matter which is the subject of the disciplinary process. There is a case for delegating this power to the OLC in the normal course of events.

f. *Compensation orders*

This power could apply to both FLRs and individual members.

The AIDB does not have the power to make compensation orders. In financial services, the FSA does not have the power to give compensation orders (though it does have the power to order restitution); rather the Financial Ombudsman Service deals with complaints and compensation.

Again, compensation orders could be imposed either on the regulatory body (which would be required to pay adequate compensation to those adversely affected by its acts or omissions, subject to LSB approval), or on individuals or individual firms. In the latter case, as it is envisaged that there will be a separate complaints body, the OLC and it may be appropriate, accordingly, to give it the power to make compensation orders instead of the LSB. However, in order to facilitate speedy compensation payments, it could be provided that if a firm has been disciplined, then the OLC will automatically consider what compensation, if any, is payable, without having to wait for those who suffered loss to initiate proceedings with it.

g. Payment of costs of disciplinary processes/verification processes

This sanction could apply to both FLRs and individual members.

The AIDB and the FSA both have the power to require those disciplined to pay for the costs of the disciplinary processes.

The Australian Competition and Consumer Commission (ACCC) also has the power to require firms to pay for the costs of any verification processes that the ACCC may require. This power operates in conjunction with its power to agree enforceable undertakings with firms (see below). An undertaking may stipulate that the firm will engage in compliance reviews and implement compliance plans. In other words, it will undertake to identify the aspects of their processes and practices which led to the non-compliance, and to remedy them. It can also require that the remedies which have been put in place verified by an independent third party to ensure that are adequate and those that were agreed. The firm can be required to pay for that verification process.

Research shows that requiring compliance reviews and verification of compliance processes, in conjunction with orders for the firm to pay for the costs of the verification, can be a very effective enforcement tool, for it requires the firm or FLR to have an ‘end to end’ review of its processes and practices, thus preventing other failings in the future.

h. Public reprimand: ‘naming and shaming’

This power could apply to both FLRs and individual members (to cover reserve LSB powers of direct regulation).

The AIDB has the power to issue public reprimands and serious reprimands. The FSA also has the power to ‘name and shame.’ This can be a very effective tool for those firms or FLRs which have a strong reputation which they are keen to protect. It can also have a very strong deterrent effect for others.

Naming and shaming is often not so effective for smaller, particularly transient, firms. However, in the context of professional regulation, it may be more effective given that firms are less transient and peripatetic, and a strong emphasis is placed on professional integrity.

It is important to note that there is a strong case for placing ‘naming and shaming’ within a framework of educative and remedial enforcement activity, in which the LSB would help the service provider or FLR to remedy their processes and practices.

It is also important to allow the LSB to do the appropriate of ‘naming and shaming’ and to issue commendations or identifications of best practice. The Board should be prepared to use carrots as well as sticks.

i. Enforceable undertakings

This power could apply with respect to FLRs and individual members.

The Australian Competition and Consumer Commission has the power to issue enforceable undertakings, and the OFT were given a similar power with respect to the exercise of their competition powers in the Enterprise Act 2000. Directors’ disqualifications can also be handled by the DTI by means of undertakings.

Enforceable undertakings are agreements reached between the regulated and regulator as to certain actions that need to be taken. The regulator is usually given the discretion to determine what the content of the undertaking should be. The undertaking is then published (the OFT, for example, posts them on its website).

There is an increasing body of research on the effectiveness of enforceable undertakings in Australia, and whilst there is a debate as to the manner in which they are negotiated, they have been shown to be an effective enforcement tool. The OFT has also made active use of its power to issue enforceable undertakings.

Examples of what could be required by an enforceable undertaking are commitments for re-training/additional training or commitments for compliance reviews to ensure future compliance with professional ethics and other requirements.

The advantage is that they are highly flexible tools which enable a forward-looking approach to enforcement. Fines etc look backwards, at what happened. Undertakings can look forward towards those actions that need to be taken to ensure that appropriate actions are taken in the future. The disadvantage is that the manner in which they are agreed is not always transparent, and care must therefore be taken to ensure that due process is observed.

j. Rights to proceed in cases of ‘undue leniency’ and other rights to intervene in the disciplinary activities of professional bodies.

This power would apply only to FLRs.

The CHRE has the power to refer disciplinary decisions by the professional bodies to the High Court if it considers that they are unduly lenient. This power has been used a number of times already.

The advantage of such a power is that it can assuage public concerns that the professional bodies are too lenient on their members. The disadvantage is that as legal proceedings are taken by the CHRE against the professional body, this can give the impression that one regulator is being pitted against the other and can negate the sense that both are working to a common aim. Further, the 5th Shipman inquiry noted that there is some legal uncertainty as to the scope of the power, which has caused difficulties. Care should therefore be taken in drafting any similar provision for the LSB.

An alternative could be to intervene in the disciplinary activities of professional bodies. The Irish Accounting and Auditing Standards Authority (IAASA) has the power to intervene in the disciplinary process of prescribed accountancy bodies. Where the IAASA is not satisfied that the body in question has complied with the investigation and disciplinary procedures already approved, it has the power to:

- Annul all or part of a decision of such body.
- To direct that body to conduct further investigation or a fresh investigation.
- To fine the body in question for not complying with the approved standards and procedures.

This option has the advantage of avoiding potentially costly and lengthy legal proceedings. The FLR could appeal to the independent tribunal if it objected to the LSB's use of this power.

k. Private enforcement options

These currently apply to the existing professional bodies and their individual members.

'Private' enforcement options are those actions which are taken by persons other than the regulators to ensure compliance with the rules and standards of the LSB and the FLRs.

Consumers can seek compensation for the conduct of an individual firm or practitioner through the new complaints system.

They can also proceed against individual law firms through the common law of negligence. Individuals can also take legal action with respect to the existing professional bodies through judicial review.

One issue is whether the rights of consumers to seek legal redress in court should be extended. Rights of enforcement through courts are problematic for consumers as they are very expensive, and therefore are rarely used by the smaller clients of legal firms. For this reason certain consumer bodies and other interested parties have been given statutory powers to bring legal proceedings against a firm for breach of certain consumer protection provisions (eg unfair contract terms).

However, given that it is proposed that a new single complaints system is to be established with powers to issue compensation orders, it does not appear necessary to extend the ability of consumer representatives to take legal action with respect to legal professionals. This recommendation is quite distinct from the recommendation below on super-complaints (para 3.7.4).

l. Whistleblowing

The provisions of the Public Disclosure at Work Act 1998 should be extended to cover disclosures to the FLRs and the LSB. This is a potentially valuable way to provide the regulatory bodies with information about unethical practices.

3.6.3 The structure of disciplinary/enforcement processes

It is strongly arguable that the investigative and adjudicative arms of the LSB should at the least be operationally distinct. The processes for disciplining FLRs should clearly be ECHR-compliant and conform to principles of natural justice and fairness, and include a right to legal representation. Both the proceedings and the decisions should be public unless there are strong reasons to justify otherwise.

One possible model to follow is that used with respect of accountants. In the case of the AIDB, hearings are conducted by a Tribunal composed of a majority of non-accountants appointed by the AIDB. No officers or employees of the accountancy bodies, the FRC or any of its subsidiary bodies may be appointed to a Tribunal, including an appeal tribunal. All hearings and decisions are public where possible, and participants have the right to legal representation.

3.6.4 Rights of appeal

It is normally the case that disciplinary (as opposed to regulatory) decisions of regulators are subject to appeal to an independent appeal tribunal.

The AIDB appeal tribunal is appointed by the AIDB. In contrast, in the case of the Financial Services and Markets Tribunal and the Competition Appeal Tribunal, these are entirely separate from the regulatory body and are appointed by the Lord Chancellor and run under the Department for Constitutional Affairs. Given the desirability of maintaining the accountability of the LSB, it would be appropriate if a similar model of independent appeal tribunal were created for the LSB with right of appeal on a point of law to the High Court or Court of Appeal.

The Financial Services and Markets Tribunal has jurisdiction over matters of fact and law. The Tribunal may consider any evidence relating to the subject matter of the reference, whether or not it was available to the FSA at the relevant time.² It may summon any person to give evidence or produce documents to it, and failure to comply is an offence. Evidence may be given on oath.³

The Tribunal has the power on determining a reference:

- To remit the matter to the FSA with such directions as it considers appropriate, which the FSA is obliged to follow.
- To make recommendations as to the FSA's regulating provisions or its procedures, which are not binding on FSA.
- To make orders as to costs.

Appeal from the Tribunal lies to the Court of Appeal on a point of law.

² FSMA s.133.

³ FSMA Sched 13 para 11.

The Competition Appeals Tribunal (CAT) hears appeals against the OFT's decisions with respect to competition provisions. The CAT hears appeals with respect to decisions made by the OFT and the sectoral regulators under the Competition Act 1998; reviews decisions made by the OFT, the Competition Commission and the Secretary of State with respect to merger references; and hears actions for damages for monetary claims under the Competition Act. It also has jurisdiction with respect to breach of some EU competition regulations and certain decisions of Ofcom.

The CAT may:

- Confirm, set aside, or vary the OFT's decision.
- Remit the matter to the OFT.
- Make any other decision that the OFT could have made, including imposing, revoking or varying the amount of any penalty.

The rights of standing are very wide. Appeals may be brought by any party to an agreement in respect of which the OFT has made a decision, or any person with respect to whose conduct the OFT has made a decision, or any third party or representative of third parties who the tribunal considers has a sufficient interest in a decision (except in relation to the imposition of a penalty) made by the OFT.

Appeal from the Tribunal lies to the Court of Appeal as to the amount of penalty or award of damages, or on a point of law arising from any other decision.⁴

3.7 Complaints

The Clementi Review favoured the creation of a single complaints handling body for all consumer complaints regarding legal services and against all LSB regulated providers. Clementi recommended that an Office for Legal Complaints (OLC) would both handle individual complaints and have a strategic role in setting targets for the handling of in-house complaint by practitioners. The OLC would oversee the front line bodies' arrangements on such matters as indemnity insurance and compensation. The Government has accepted the Clementi recommendations on the OLC. This section accepts the establishment of the OLC as a given and that the OLC would deal with redress for consumers but refer conduct complaints to front line bodies so that these can be dealt with by FLR disciplinary structures. This section, however, discusses a series of issues concerning the LSB's role in such arrangements.

3.7.1 OLC Independence from the LSB

A first issue is whether the OLC should be a self-standing body with its own statutory objectives. The argument against this, as the Clementi Report notes, is that protection of consumers is encompassed within the objectives of the LSB and that giving the OLC separate objectives would create potential confusion. The Clementi Review argues convincingly in favour of granting the OLC autonomy regarding individual complaints issues and in support of the OLC having separate staffing and branding. Clementi, however, would grant the LSB powers of oversight over the OLC in respect of systemic and policy issues. (This reflects

⁴ CA s.49 (as amended by EA Sched 5 para 4).

practice in the financial services sector where the Financial Ombudsman Service (FOS) has a separate board but its overall functions are subject to oversight by the FSA). The advantage of LSB oversight is that this would offer the LSB comprehensive control over those matters relevant to the meeting of its statutory objectives. It would encourage co-operation between the LSB and OLC and would avoid the dangers of duplication that might flow from a wholly independent OLC.

Such reasoning suggests that the OLC should be supervised by the LSB regarding systemic and policy issues but not in relation to individual complaints; that the OLC should work to objectives that are laid down by the LSB; but that the LSB should be obliged to consult the OLC before laying down or amending such objectives.

As for the appointment of the OLC chair, this might be carried out by the Secretary of State or the LSB. The OLC functions, however, place a high premium on fairness and accordingly, there is a case for distancing the appointment from government by providing that this is an LSB responsibility. It may also be advisable to involve key stakeholders in such a process by making all appointments subject to the concurrence of the judiciary and key stakeholders such as frontline bodies and consumers' organisation.

3.7.2 The Accountability of the OLC

The logic of the above arrangement suggests that the OLC should not be directly accountable to Parliament on systemic and policy matters but that the LSB should be. The Chair of the LSB would accordingly be responsible for OLC issues other than individual complaints and would appear before Select Committees. The OLC would, however, publish its own annual report and this would contribute to openness and transparency. In relation to individual complaints handling, the LSB would, as noted, have no oversight role and there would be no justification for an appeal from the OLC to the LSB (there are strong arguments, indeed, for having no appeals against OLC complaints but that matter is beyond the scope of this paper).

3.7.3 Conduct issues

Particular difficulties arise when complaints involve conduct (as opposed to service) issues. These may raise questions of a systemic and policy nature as well as disciplinary matters. It might be proposed that the LSB should handle conduct issues but the danger is that this would cut across the OLC's complaints role and the FLRs' disciplinary roles, and create both duplication and confusion. The way forward may be to provide that the OLC should pass on conduct issues to front line regulators (as noted above) but that the following arrangements should apply:

- The frontline bodies would report back to the OLC on conduct cases and their resolution. The OLC would report to the LSB on all conduct cases and identify any systemic or policy issues demanding LSB attention (Where these are identified the FLR would also be informed).
- The LSB would deal with systemic and policy matters arising in conduct cases but not with disciplinary matters or with the hearing of particular cases.
- The LSB would have powers to call on the OLC to provide detailed information on any or all aspects of conduct cases.

- All the disciplinary tribunals of the FLRs should report annually to the LSB on their powers, procedures and cases processed. In order to encourage consistency of approach and best practice across front line regulators, the LSB should oversee arrangements and be empowered to recommend to the FLRs any variations in powers or procedures that may seem appropriate to the LSB. As discussed above, the LSB should also have the power to require the FLRs and their tribunals to make any such changes as it considers appropriate subject to the conditions noted above in its use of powers of direction with respect to FLRs (i.e. that such direction is in accordance with the LSB's statutory objectives, and the FLR has been consulted beforehand).
- Where the OLC deems that a complaint involves conduct and service issues, it should have the discretion to delegate the whole complaint, in all aspects, to the FLR for resolution (a position encountered in various Australian states). The conduct/service distinction is difficult to draw in many cases (e.g. a barrister is accused of neglect or of collusion with the other side). Allowing the OLC to delegate the whole complaint reduces dangers of duplication and of one regulator being presented with a fait accompli by another. In such cases the FLR would report back to the OLC.

3.7.4 *Super-Complaints*

The Enterprise Act 2002, Section 11, created a system of 'super-complaint' to the Office of Fair Trading (OFT). Under this provision, certain consumer bodies, designated by the Secretary of State, have the right to complain directly to the OFT where they consider that there is a market feature (such as a market structure or a practice of conduct by those operating in it) that maybe harming consumers to a significant extent.

The aim of the procedure is to encourage consumer representative groups to make complaints on behalf of consumers collectively and to oblige the OFT to respond to such complaints within a specified time (90 days in the case of the OFT).

In the legal services sector there is a case for establishing an analogous regime in order to protect consumers. It can be argued that this is so because consumers of legal services are especially vulnerable. They are, for instance, often non-expert, non-repeat players who make decisions under severe time, resource, and other pressures. A super-complaint system would allow consumer representative organisations (and perhaps the OFT) to bring market failures to the regulator's attention and this would both protect consumers and provide a useful source of information for the regulator.

Should the super-complaint be made to the LSB, the OLC or the front line regulator? It is in the nature of the super-complaint that it relates to a general feature of a market or of conduct. As such, it raises issues that are systemic or policy in nature. It follows, accordingly, that if the LSB has overall responsibility for systemic and policy matters, it should be a recipient of super-complaints and should deal with these. In some cases it may be appropriate for the LSB to refer a matter that has arisen to the OLC (e.g. where the super-complaint points to a systemic failing in the OLC's processes for dealing with a certain type of complaint). To provide for such instances, the LSB should have the freedom to pass these issues on to the OLC and the power to direct the OLC to deal with them and to report back to the LSB on actions that it has taken. An FLR should be required to pass any super-complaints that are made to it.

3.7.5 *Appeals from OLC decisions*

In some jurisdictions the decision of a complaints body is binding on the complainee but the complainant is free to appeal to the High Court on a point of law. This may be seen as harsh on the complainee but is likely to appeal to consumer groups. Service providing firms can be expected to argue that the importance of OLC rulings to their reputations justifies reciprocity.

3.8 *Other powers and functions*

Certain other general powers are commonly given to other regulators of professional bodies and these may be considered in relation to the LSB. Notable are the following possibilities.

Options

- a. A general power to require / recommend that regulatory bodies take active steps to promote the statutory objectives*
- b. Powers/duties to advise Government and give reports on matters relating to the legal profession*
- c. Powers/duties to participate in international fora or standard setting bodies*
- d. Powers to approve the professional bodies' strategic direction, business plans, budgets and staffing arrangements*

Table 4: Summary of Options for the Powers and Functions of the Legal Services Board

This table is intended to clarify the key decisions and options with respect to the powers and functions of the LSB, with the exception of those relating to complaints.

In most cases, the key issues are:

- Should the power be advisory or directory (i.e. power to recommend or power to require).
- Should the power apply to the FLRs only.
- Should the power apply also to individual members of the FLRs, and if so in what circumstances.

With respect to the structure of the disciplinary processes, a central issue is whether the options considered should be adopted at all.

n/a means that the issue does not arise.

Powers and Functions	Nature of the power: to recommend only?	Nature of the power: to require FLRs to comply?	Nature of the power: to require individual members to comply?
1 Approval / recognition of FLR			
a. Approval against broad statutory criteria			n/a
b. Approval against detailed, LSB formulated criteria			n/a
c. Approval against detailed statutory criteria			n/a
d. Statute stipulates which bodies the LSB will regulate (i.e. no approval powers)			n/a
2 Standard setting			
a. Power to issue rules or principles			
b. Power to approve rule changes of FLRs			n/a
c. & d. Powers to recommend changes to rules of FLRs, or power to require changes in certain circumstances			n/a
e. Powers to obtain changes to anti-competitive rules / practices of FLRs			n/a
3 Monitoring and Investigation			
a. General monitoring power plus duty to co-operate; no sanction for non-cooperation			
b. Powers of investigation and to request information			
c. Powers of entry, search and seizure			
d. & e. Powers to direct or recommend that FLRs undertake monitoring and investigative activities			n/a
4 Enforcement: Powers of Discipline and Sanction			
1. Application and nature of enforcement powers			

2. Options for sanctions and other enforcement techniques			
• a & b. Suspension / revocation of licence			
• c. Fines			
• d. Adjustment of fees / levies			
• e. Waiver / repayment of client fees			
• f. Compensation orders			
g. Payment of costs of disciplinary processes/verification processes			
• h. Public reprimand: 'naming and shaming'			
• i. Enforceable undertakings			
• j. Rights to proceed in cases of 'undue leniency' and other rights of intervention in PB disciplinary processes	n/a		n/a
• k. Private enforcement options	n/a	Existing	Existing
• l. Whistleblowers' protection	n/a		n/a
5. Structure of Disciplinary and Enforcement Processes			
1. Separation investigation and adjudication functions within LSB or separate body			
2. All adjudication proceedings and decisions public			
6. Rights of appeal to independent tribunal			
a. Right of appeal to independent tribunal			
b. Appeal from Tribunal to Court of Appeal			
7. Education and Training			
a. Approval of FLRs' educational, training and professional qualifications to be part of approval / recognition criteria			n/a
b & c. Powers with respect to changes to FLRs' rules, standards and practices on education and training – recommend or direct?			n/a
8. Other Powers and Functions			
a. General power to require/recommend that regulatory bodies take active steps to promote the statutory objectives			n/a
b. Powers/duties to advise Government and give reports on matters relating to the legal profession	n/a	n/a	n/a
Powers/duties to participate in international fora or standard setting bodies	n/a	n/a	n/a
Powers to approve/recommend or require changes to the FLRs' strategic direction, business plans, budgets and staffing arrangements			n/a

4. **Strategies for Intervention**

In considering strategies of intervention, central issues are how the LSB should use any monitoring, inspection, and enforcement powers and how it should target its interventions regarding the activities of professional bodies and forward/or individual members.

Three key strategies are considered:

- Risk based approaches.
- Compliance, educative and models of enforcement.
- Responsive regulation.

4.1 Risk based regulation

4.1.1 What risk based regulation involves

The recent Hampton Review of Inspection and Enforcement (March 2005) recommended that all regulatory agencies should adopt a risk based approach to regulation.

Risk based regulation can mean one of four things:

- ***Setting standards/ rules which are applied to a whole set of regulated firms/ organizations on the basis of assessments of the risks posed to society by the activities of firms of that type.***

The focus here rests on the regulation of risks to society: risks to health, safety, the environment or less usually, financial well-being. Regulation is 'risk based' in the sense that assessments of the risks that certain types of conduct pose, to the environment, for example, are used to set standards of conduct which apply generally. In this respect, 'risk based' regulation has long been used in food safety regulation, or health and safety regulation in the workplace, for example, to determine whether or not an activity should be regulated, or what level of preventive measures firms should take.

- ***Setting standards tailored to fit the particular risks which the conduct of particular firms gives rise to.***

Risk based regulation in this sense involves tailored or targeted rule making. For example, in banking regulation talk of a move to risk based regulation widely refers to the introduction of individual risk assessments of a bank's financial position based on the firm's own internal risk models, and the setting of individualized capital adequacy requirements. In the environmental field, the introduction of 'fit for purpose' risk assessments for the remediation of contaminated land and for the disposal of contaminated waste in the US and the UK is sometimes referred to as 'risk based' regulation.

- ***The introduction of internal risk management systems within the regulatory agency.***

The risks focused on here are the risks to the organisation's ability to operate effectively, and the sources of risk are seen to arise principally from within the organization itself. They include inadequate contracting or procurement processes; inadequate IT systems; poor

business continuity planning, inadequate internal controls or human resource planning, and so on.

- ***Allocating resources, mainly inspection and enforcement resources, based on an assessment of the risk that a regulated person poses to the regulator's objectives.***

This is the principal sense in which risk based regulation is used in the Hampton Review on Inspection and Enforcement (March 2005), and the sense in which it is used here. The key components are an assessment of the risk of non-compliance, and an assessment of the impact that the non-compliance will have on the ability of the regulatory agency to achieve its objectives.

Turning to risk management systems, the central tasks are: risk identification; risk assessment; risk management; and review and reporting. The standard formula for assessing risk is: Risk = Probability x Impact. In the legal services context, a risk based approach to regulation involves a number of elements that ought to be considered. These are as follows:

- ***Identifying regulatory objectives and turning them into operational goals***

This would require the LSB to take each of its objectives and turn them into organisational goals which can be operationalised. Depending on how those objectives are worded, this may or may not require some rationalisation and re-phrasing (As noted above, the FSA has 'translated' its four statutory objectives into seven 'risks to objectives').

The LSB would also need to identify where those goals may operate in tension with one another, and will have to consider how it will resolve any trade-offs that may need to be made.

- ***Identifying the sources of risk? (Asking why the LSB might not achieve its objectives?)***

Such sources of risk may be three fold. Risks may arise from the conduct of the FLRs; they may stem from the conduct of individual members; or they may have origins in broader environmental sources – thus changes in the organisations' operating environments may affect risks to LSB statutory objectives (e.g. the development of new markets for legal services, new business forms etc).

- ***Specific assessments of the probability that the risk will occur***

Risk assessments need to be specific to each FLR, firm or individual. Assessment of broader environmental risks may have to look to each change or development in that environment.

When focusing on FLRs or individual members, specific risk assessment will take on board such matters as inherent risks and management and control risks. The former are risks arising from the type of activity that FLR/legal practitioner undertakes. Management and control risks are those risks that arise from the management and governance structures of the FLR/legal practitioner.

- ***Assessing impact***

This involves assessing the impact of the non-compliance of a professional body/individual firm on the LSB's ability to achieve its objectives, or on the impact of an event or change in the general environment in which the firms operate.

It requires the development of metrics for measurement – in other words, ways must be found to assess how serious an impact on the LSB's objectives will be caused by the professional body's or individual member's conduct.

- ***Categorising/ranking of professional bodies/individual members on the basis of the probability and impact assessment***

It is normal to have at least a three-fold classification of High, Medium and Low risk. It is preferable to have a more detailed classification to enable slightly more fine-grained distinctions to be drawn (and to avoid everyone ending up in the 'medium' category): e.g. Very Low, Low, Medium-Low, Medium-High, High.

- ***Using the categorisation to determine the LSB's activities***

In employing risk analyses to guide LSB intervention, a first need is to determine the LSB's risk tolerance. Clearly the LSB has to focus on serious risks. A key issue is how serious a risk has to be before the LSB invests resources in trying to prevent it.

Given that it is impossible to eliminate all risk, this involves a decision as to the level of risk to the LSB's objectives that it should *not* spend resources trying to prevent.

The LSB can then decide how it will respond to an individual risk assessment of an FLR professional body or individual member. It may, for example, use the risk assessment in deciding on the frequency and intensity of monitoring/inspection. In some risk based approaches, all those regulated are still inspected; in others, only those ranked in the higher categorisations are inspected. The LSB may also make decisions about the nature of its overall relationship with the FLR or individual member. Similarly, such assessments can be taken into account in deciding what other action to take: e.g. raising fees or levies for those professional bodies in higher risk categories.

- ***Reviewing and reporting: assessing the effectiveness of risk based systems***

This is a key part of a risk based system. The main elements involve developing performance measures and developing feedback systems so that those responsible for performing the individual risk assessments can communicate their experiences and observations to those responsible for designing the risk based approach and other senior officials within the organisation. Also required are systems of reporting to the public and the regulated community of the risk based approach and systems for modifying and revising the risk based approach in the light of the review.

- ***Risk-return regulation***

It is arguable that an efficient model of risk based regulation involves targeting resources not at greatest risks but at greatest opportunities for risk reduction. Some risks will be easily

reduced, some will demand highly intensive action. If the LSB espoused a risk-return approach it would assess not merely activities that present serious risks to achieving its objectives but also the costs of reducing those risks. An efficient use of regulatory resources would, accordingly, avoid simply targeting the most serious risks – it would seek to maximise the risk-reducing return from a given regulatory effort.

4.1.2 Examples of risk based approaches

Risk based approaches to regulation are being developed and implemented by a diverse range of regulators. The Hampton Review reported that 36 regulators stated that they based their inspection regime in part on risk assessments, though it queried how ‘risk based’ they were in practice.

Examples include the following:

- Health and Safety Executive
- Environment Agency
- Financial Services Authority
- Food Standards Agency
- HM Revenue and Customs
- Scottish Care Commission
- Housing Corporation
- Gaming Board
- Commission for Social Care Inspection
- Pensions Regulator

At the moment, most of these take the form of a risk based approach to the deployment of resources for inspection, and to some degree enforcement.

▪ ***Health and Safety Executive***

The Health and Safety Executive probably has the longest track record of risk based approaches to inspection – which are currently contained in its Enforcement Policy Statement and Enforcement Management Module. It has emphasized the spirit of a risk based approach in its long term strategy documents (though it has not deployed the terminology).

▪ ***Food Standards Agency***

Responsibility for enforcing food safety standards lies with local authorities. The Food Standards Agency oversees their activities, though it has few powers to direct them in any way. The 1995 Code of Practice which accompanies the Food Safety Act 1990 sets out in some detail an inspection rating system which is intended to determine the frequency with which premises are inspected by local authorities under the Agency’s oversight.

▪ ***Environment Agency***

The Environment Agency has been developing a risk based approach to inspection as part of its ‘modern approach’ to regulation (*Delivering for the Environment – A 21st Century Approach to Regulation*, 2004). Its risk based approach centres on an Operator Pollution Risk Appraisal. This is a tool of risk assessment which determines the environmental hazards

associated with a site and how well these are being managed.’ The Appraisal includes an assessment of a site’s emissions, location, complexity and prior compliance record, and will determine both the frequency of inspections and the fees that will be charged.

- ***HM Customs and Revenue***

HM Customs and Revenue has been developing a ‘risk based’ approach to the detection of fraud in the import of spirits and oils. In April 2003 it also launched the VAT Compliance Strategy, in which investigative resources are targeted in accordance with a risk assessment of non-compliance, focusing particularly on small and medium enterprises.

- ***Pensions Regulator***

In 2002-3, the Occupational Pensions Regulatory Authority, replaced by the Pensions Regulator in April 2005, began work on developing a ‘proactive risk framework’ which will identify schemes that pose greatest risks to members’ benefits and which will determine the nature of the regulatory relationship between the firm and the regulator.

- ***Commission of Healthcare Audit and Inspection/Healthcare Commission***

The Concordat on healthcare inspection includes the objective that inspections are ‘weighted to risk’. Healthcare providers will be given the incentive to improve their compliance through ‘earned autonomy’: less frequent or intense inspections, or inspection holidays.

- ***Financial Services Authority***

The FSA’s risk based approach, ARROW, is a detailed assessment of the risks each individual firm poses to the FSA’s objectives. ARROW also includes an assessment of the broader environment. It has, as noted, turned its four statutory objectives into seven risks to objectives.

It has categorized the firms it regulates mainly on the basis of impact. There are four categories ranging from A (high impact) to D, low impact. Only those ranked above low impact (Category D) will receive individual risk assessments. In practice, less than 20% of regulated firms are above Category D and so are individually assessed.

When individual firms are assessed, the assessment looks to each of the seven ‘risks to objectives’, or RTOs. There are two sets of risks: the risks arising from the nature of the business the institution conducts, and management risk, i.e. the risks posed by the firms’ corporate governance structures and systems of internal control. To give some idea of the level of detail involved, inherent risk is in each case disaggregated into five main risks and a further fifteen separate risk elements. They include such risks as the types of markets or products being dealt in, the nature of an institution’s counterparties, its operational risk, the nature of its business strategy, and its legal and regulatory risk. Management and control risk is divided into five categories, and then further disaggregated into twenty separate risk elements. These include assessments of the quality of board oversight, of internal audit, financial and risk management functions, and compliance.

There is a considerable difference in the supervisory relationship between firms in different categories. Category D firms receive very little interaction from the FSA. They will not be

visited except as part of a ‘themed’ visit (when the FSA will inspect a certain line of business). There are no routine, or even random, visits. Calls from those firms are directed to a call centre, and monitoring is based on sampling of regulatory returns. In contrast, Category A firms (high impact firms) are monitored on a ‘close and continuous’ basis. There are dedicated teams working with those institutions, they are individually assessed, and receive close and constant monitoring.

4.1.3 Advantages and disadvantages of a risk based approach

A risk based approach has a number of advantages:

- It could provide a systematic framework to enable the LSB to relate its activities to the achievement of its statutory objectives.
- It could help the LSB to prioritise resources.
- It could help the LSB to respond to changing circumstances by providing it with a framework to help it to assess how important the issue is with respect to its objectives.

However, there are some potential drawbacks and limitations presented by risk based approaches and these can themselves pose risks:

- The risk based approach may be flawed in its design.
- The framework may be badly implemented, for a number of reasons. Staff may be insufficiently trained; there may also be a lack of support from senior management. Risk based approaches involve not doing things, and it is important that senior management recognize and support this. Further difficulties arise when there are inconsistencies in assessments between officials; when there is a lack of resources to establish the system properly; when risk based monitoring is not supplemented with random inspections; and when there is no system for feedback of the risk based approach or for reviewing its effects.
- Risk based approaches may also involve dangers that politicians and the public will not support the LSB’s decisions regarding the risks it will invest resources in preventing, and on the particular risks or levels of risk it will *not* spend resources trying to prevent.
- If poorly designed and implemented, risk based approaches can impose increased regulatory burdens on those being regulated.
- Risk based approaches are a departure from universal regulation, which in theory gives equal protection to all beneficiaries of regulation (but not always in practice), and which may be necessary to maintain public confidence in the regulatory system and those being regulated: the importance of ‘bobbies on the beat’.

4.2 *Compliance, educative and deterrence approaches to enforcement*

When the LSB assesses that an FLR or individual member is not acting as it should, it has to decide whether or not to take enforcement action. In doing so, it can adopt a number of approaches, as follows.

4.2.1 *A compliance approach*

A compliance approach is one in which the regulator negotiates with the professional body or individual member regarding the changes that need to be made in their operations, governance systems or other activities in order to ensure compliance.

Arguments usually put in favour of adopting a compliance approach are principally:

- It involves an efficient use of resources (persuasion is cheap).
- It will elicit a more co-operative approach from the FLR or individual member and will contribute to sustaining good work relationships.
- More information from the FLR or individual member is likely to be forthcoming about its practices and possibly about areas of non-compliance.
- It will engage the FLR/individual member in decisions on best to act to secure compliance.
- It allows rules to be adjusted to fit the individual circumstances of the FLR or individual member.
- It allows identification of the best ways to improve performance, and because learning is involved; can improve compliance before harm results, so improving responses to risks.

On the other hand, a compliance approach may be exploited by the FLRs or individual members, leading to ineffective regulation and indicating that the LSB has been ‘captured’ by those it is regulating.

4.2.2 *Educative approaches*

Educative approaches are akin to compliance approaches, but involve a more conscious emphasis on educating those being regulated on both the requirements of the regulations and on how to comply. They involve the regulator engaging in a process of educating regulated persons on how they can change their practices and governance arrangements to ensure compliance.

This type of approach has been found to work well for small and medium firms, where knowledge of the regulatory requirements is often very low. The advantages and disadvantages are largely as with the compliance approach, above.

4.2.3 *Deterrence strategy*

Under a deterrence strategy, full use is made of formal enforcement powers, both to sanction the particular regulated person, and to send a deterrence signal to others. ‘Three strikes and you’re out’ is an example of a deterrence strategy.

Arguments in favour of a deterrence approach are that:

- It indicates a tough regulatory approach in which non-compliance is treated as unacceptable.
- It reinforces and gives effect to the regulatory requirements.
- It increases the incentive to comply.
- It can force a change in management culture and operations.

The disadvantages are:

- It can lead to regulatory unreasonableness.
- It alienates those being regulated and can lead to a game of regulatory ‘cat and mouse’, with FLRs/individual members complying only with the letter not the spirit of the rules, and regulators trying to devise more and more specific rules to block loopholes.
- It only works where those being regulated are fully informed both as to the rules, the likelihood of detection and the costs of non-compliance; where misbehaviour is unambiguously defined; where formal sanctions provide the primary incentive for compliance; and where enforcement agents optimally detect and punish behaviour given available resources.

4.3 *Responsive regulation*

As opposed to another, the more profitable approach is to consider which combination of strategies is most appropriate in which circumstances.

A responsive regulation approach was first suggested by Ian Ayres and John Braithwaite in 1992, and research has shown that it can be effective. There are two elements to the strategy:

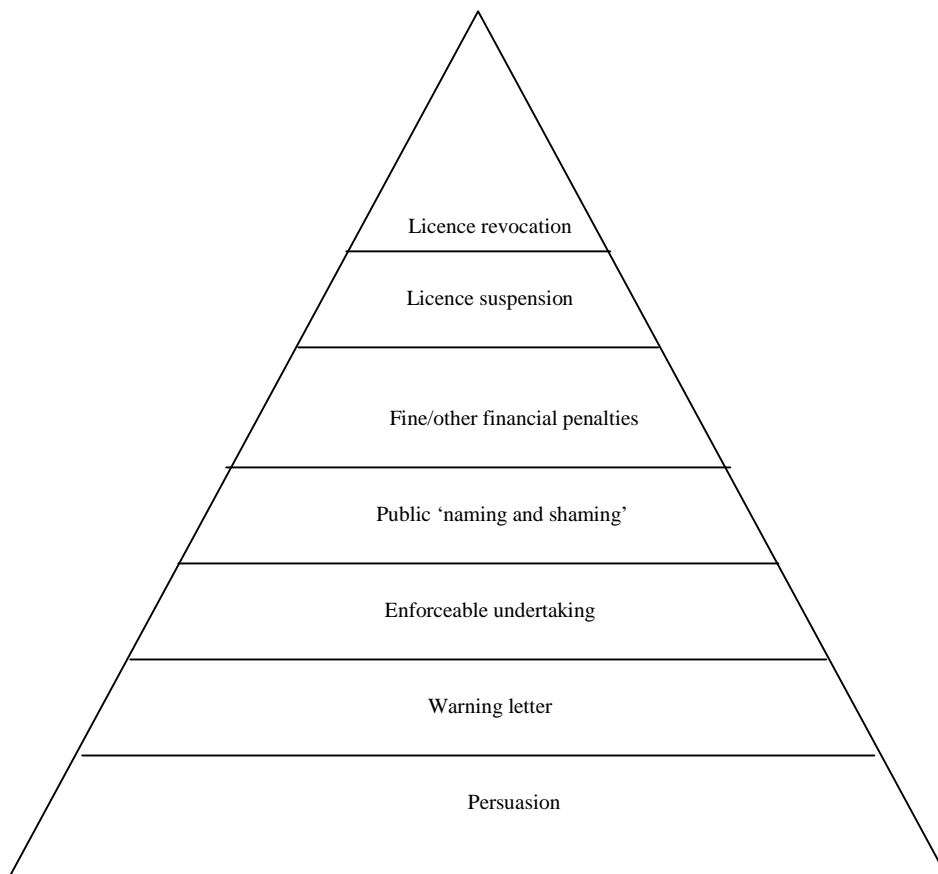
- A line of action strategy which the regulator adopts in its dealings with the individual member. If the regulatee is being co-operative, the regulator adopts a more compliance-orientated approach. If it is not, then a more deterrence based approach is applied.
- A sanctions or enforcement pyramid in which the regulator has a range of sanctions at its disposal and applies these with varying degrees of severity.

4.3.1 The enforcement pyramid

The key part of a responsive strategy is the enforcement pyramid, or sanctions pyramid.

Regulators move progressively up the pyramid, starting with a persuasive approach, which employs no sanctions and gradually moves up through the hierarchy until the most severe punishment is reached. Just what sanctions the pyramid will contain should vary with the area being regulated, the important matter is there should be a range of responses available to the regulator and that these offer differing degrees of severity. Enforcers need a range of credible sanctions that enable them to match sanction to the form of non-compliance. Crucially, regulators can speak softly if they carry big sticks.

An example of a sanctions pyramid is:



The advantages of a responsive strategy are that:

- It allows the regulator to adjust its enforcement activities to meet the stance and needs of the individual firm.
- It facilitates flexible and proportionate enforcement.

The disadvantages are that:

- Some regulatees maybe irrational and unresponsive when faced with tit for tat approaches – which may make them wasteful.
- The regulator may be slow to (or never) move up the pyramid, leading to under-enforcement.
- A strategy of moving up the pyramid may not be appropriate in the face of a severe or catastrophic risk (which may call for immediate and severe action).
- The regulator needs to have a wide range of credible sanctions available in order to deploy the strategy effectively.
- Efficient use of regulatory resources may demand a targeting of enforcement and a by-passing of certain levels of the pyramid.

4.3.2 Risk based approaches and responsive regulation: are they compatible?

Where risk based approaches are used to determine overall monitoring and inspection activities, these can be used in conjunction with a responsive strategy for enforcement. To this extent, strategies of risk based regulation and responsive regulation are compatible.

However a risk based approach can operate in tension with a strategy of responsive regulation where a risk based approach extends to the use of enforcement resources.

A risk based approach to enforcement requires a targeted use of enforcement resources, based on the risk assessment of the FLR or individual member. So even if an FLR or individual firm which has been categorised as low risk and low impact is not complying and not co-operating, a risk based strategy would suggest almost no sanction (or more accurately, the investment of no resources to impose a sanction). In contrast, a responsive regulation approach would suggest quite a severe sanction, even though imposing this sanction may consume an amount of regulatory resources that are disproportionate to the risk.

The risk based approach would also suggest the use of quite a severe sanction for those FLRs or individual members categorized as high probability and high impact, even when they might have been co-operating with the regulator. The deterrent effect of the sanction could be calculated to be an efficient use of resources. In contrast, a responsive strategy would be to continue to negotiate with the FLR to improve compliance rather than to impose a sanction.

In summary, the main differences are:

- Responsive regulation and the enforcement pyramid involve a ‘tit for tat’ enforcement strategy together with a practice of escalating up a tier of sanctions that is based on the response of the individual professional body/member firm to the regulator.
- Risk based regulation involves a deterrence-based enforcement strategy together with the targeted use of enforcement resources that is based on the regulator’s risk categorisation of the professional body/member firm.

The LSB would therefore have to decide the extent to which it should modify its risk based approach when considering its enforcement strategy, and whether it wished to adopt a more responsive approach to enforcement instead.

4.3.3 Risk-Return Regulation and Responsive Regulation

One way to reconcile the targeting of risk based regulation with the responsive regulation strategy is for the regulator to prioritise its enforcement efforts according to an analysis of risk returns – one that identifies those regulatees and activities that offer the highest levels of risk reduction per unit of regulatory resource – but to do so on the assumption that the most efficient way to deploy that resource in a given case maybe to operate with a responsive approach. This ‘hybrid’ enforcement strategy adopts as its central aim the lowest cost reduction of risk. Its strength lies in its efficient use of resources.

Such a concern for efficiency prompts consideration not merely of the mode and targeting of interventions but also the *timing* of interventions. The LSB may, on some issues, find it efficient to intervene to prevent a risk from arising (e.g. by applying a system of prior approvals of behaviour or by screening entry to an activity). On some issues, however, it maybe efficient to allow the front line regulator to engage in an activity and to monitor and regulate the carrying out of that activity on an *ex-post* basis.

The weakness of a risk-return/responsive strategy is that the public may demand that certain high level risks are dealt with as top priorities whereas the risk-return/responsive approach would give these a lower priority if the costs of securing risk reductions are high.

4.4 Strategies for intervention and LSB Powers

An LSB, it is clear, could adopt a number of strategies for intervening in the activities of front line regulators or members. It is desirable, accordingly, that the LSB’s framework of powers and governance allows it to deploy the optimal intervention strategy or combination of strategies. The implication of the discussion in this section is that an effective LSB may need to be equipped with the following:

- The resources that allow it to conduct assessments of material risks to achieving its objective.
- The powers to demand such information from front line regulators as would allow it to carry out risk assessments.

- The powers to carry out random monitoring and inspection exercises in order to secure information on new or changing risks to objectives.
- The discretion to target and prioritise intervention strategies or sanctioning in the manner of its own choosing.
- Freedom from any statutory inspection cycle or other legal restraint on its choice of intervention strategy.
- A full array of intervention powers, tools and sanctions with respect to FLRs and, in certain cases, individual members, so that it can escalate, if necessary, up a complete pyramid of responses.
- The freedom and power to intervene in regulated activities at the timing of its choice. As discussed above, this will involve broad powers to issue directions or guidance; powers to take action on a preventative or ex-post basis; and the powers to demand both information and any other actions, including remedial action, that the FLRs and in certain cases individual members should take in order to further LSB objectives.

5. **Low cost regulation and competition**

5.1 *Strategies for controlling regulatory costs*

Recent work by the Better Regulation Task Force (BRTF) and others has focussed attention on the need to control regulatory costs and ‘cut red tape.’ The design of new regulatory arrangements must pay close attention to these issues.

The proposed regulatory structure for legal services will involve costs at four levels:

- Selecting/monitoring the regime (DCA).
- LSB.
- FLRs.
- Regulated firms.

Each of these levels will involve one-off start-up or transitional costs and recurring costs. The following discussion deals with the lower three tiers (excluding the DCA) and concentrates on recurring costs.

As with other resource allocation problems, decisions about how many resources to devote to regulation have three dimensions:

- Avoiding waste (productive efficiency).
- Choosing the right intensity of regulation (allocative efficiency).
- Controlling regulatory costs over time (dynamic efficiency).

The second and the third of these are intimately linked with the development of competition in legal services markets, which is discussed in the following section.

5.1.1 Productive efficiency

Regulated firms have an incentive to meet regulatory obligations (to supply data, for example) in a way which minimises their costs, including the penalties associated with any infractions. It is more questionable whether regulatory bodies have similar incentives. More plausibly they will be guided by a mixture of motives, one of which may be to maximise their expenditure, institutional size or head count.⁵ In other words, the organisation's objectives may cut across the grain of productive efficiency.

Is this a problem in practice in a context in which independent regulators' costs – and hence the levies they can charge regulatees – are scrutinised by the Government? A review of the UK utility regulators, carried out for H.M. Treasury in 2001 by W. S. Atkins, made the following key findings and recommendations⁶:

'There are three main areas of concern. The first is the amount of information made available on which to judge their efficiency. Since the cost of regulation is continuing to rise for most regulators, it is not unreasonable to ask them to make a business case for their main items of expenditure and report on their performance. Second, the cost of support services such as finance, HR and IT is relatively high and on average accounted for about 22% of the regulators' total expenditure in 1999/00. The regulators do not publish information on activity levels and performance indicators to justify this level of expenditure on non-regulatory activities. Third, we think that the regulators need to have a bigger cadre of senior professionals but with fewer staff supporting them, salaries should be increased, and funds switched progressively from consultants to staff.'

'We would like to see more accurate costing of activities and post-implementation reviews of major consultancy projects. Consultation should commence earlier than at present to provide stakeholders with more opportunity to shape the regulatory agenda. We think that this will reduce the burden on regulated companies and the amount of non-productive work for the regulators. In order to reduce staff turnover, which will have many benefits besides reduced recruitment and training costs, the regulators should be allowed to pay competitive salaries to top people – although we would expect the number of staff overall to fall. Since the regulators are strong and weak in different areas, we think that they should be learning from each other applying the lessons learned.'

A second issue is efficient scale. A recent report by Philip Hampton, for H. M. Treasury,⁷ has focussed *inter alia* on the costs of alternative regulatory structures, noting that small regulators have higher staff costs (though this may reflect differences in the balance of staffs) and, in some cases, higher activity costs. To meet this problem, he recommended that 31 of the national regulatory bodies he reviewed should be consolidated into seven. Reasoning of this kind should influence the structure of legal regulatory bodies, although account should also be taken of the benefit the LSB will derive from comparative information on a range of FLRs.

⁵ This view of public bodies' objectives goes back to William Niskanen and beyond.

⁶ *External efficiency review of the Utility Regulators*, W. S. Atkins and H. M. Treasury (2001) pp. v, x.

⁷ Philip Hampton, *Reducing administrative burdens*, H. M. Treasury, March 2005.

Academic commentators have criticised mounting expenditure on regulation. Boyfield and Ambler⁸ produce data suggesting that between 1996/7 and 2002/3 there was an 80% 'like-for-like' increase in expenditure and a 23% increase in headcount. Much of this they attribute to increasing regulatory activity, but other cost-enhancing factors are also in play. For example, they attribute OFWAT's relatively low costs to the fact that it is located outside London.

Two utility regulators, Ofgem and Ofcom, have themselves accepted cost reduction obligations voluntarily, adopting the same type of real terms reduction (RPI-X) they impose on their regulatees as price controls. In both cases, however, the agencies experienced rapid expenditure growth before volunteering for the obligation.

While this approach is important, it is only partial. Recent attempts to quantify regulatory costs have focussed on those imposed on regulated firms. In the past, these requirements have not been costed, and it has been claimed that regulators impose or even 'shift' costs to regulatees, by imposing administrative and compliance costs on them. This issue has been opened up by the BRTF, which has recommended adoption of a standard cost model, originating in the Netherlands, which identifies and costs, using a standard labour charge for each type of function, each information obligation imposed.⁹ The BRTF proposes that the cost model be used to generate a systematic measurement of the 'administrative burden' by May 2006 and that targets to reduce it should be set thereafter. In the legal services sector the LSB would be the appropriate body to develop a system of measuring the burdens involved at different control levels throughout the regulatory system.

In relation to legal services regulation, the following conclusions flow from this brief analysis of productive efficiency:

- Transparency, in the form of clear targets and public reporting of their attainment, is a useful method of counteracting weak incentives on regulatory bodies to control costs.
- The LSB should develop and apply a system for measuring burdens at all levels of control in the regulatory system. The focus should be on total costs at all three levels (LSB, FLRs, firms); shifting regulatory costs to firms will ultimately raise prices to end users.
- The LSB should have a role in controlling FLRs' costs, (i.e. to utilise the LSB's incentives to control tendencies towards inefficiency on the part of FLRs and informal comparisons of different FLRs (a version of 'yardstick competition') can help in this process.
- The balance at any level between highly skilled/highly paid and less skilled/less well paid staff is fundamental to efficiency. The Atkins report suggested that there was a need to resist a regulators' bias towards a high head count which should be resisted.

⁸ Keith Boyfield and Tim Aubler, *Do the regulatory agencies provide taxpayer value?* London Business School, Centre for Marketing Working Paper, 04-907.1, March 2004.

⁹ Better Regulation Task Force, *Regulation- less is more: reducing burdens, improving outcomes*, March 2005

5.1.2. Allocative efficiency - the right intensity of regulation

Even if regulatory processes are perfectly cost-effective, there is still the question of how much regulation should be carried out. This depends upon the regulator's objective, set from outside, and other key features of the environment, such as the extent of market failure.

We have discussed objectives in Section 1 above. For current purposes, the key components identified can be described as the pursuit of confidence in the legal system and rule of law (a 'public value' or 'citizen' objective, generating an external benefit to all), protecting users of legal services (a 'private value' or 'consumer' objective) and ensuring that regulation is i) cost effective (an 'internal' requirement) and ii) promotes competition (thus benefiting consumers and reducing regulatory costs – see 5.2 below).

Boyfield and Ambler blame much of the increase in regulatory costs since 1996/7 on the proliferation of non-economic objectives¹⁰ and propose that the latter be abandoned or achieved through non-regulatory means. In the case of legal services, this does not seem to be feasible, but a clear separation in the regulators' eyes between economic and non-economic objectives and the ways of achieving them is necessary: otherwise, practices may be adopted which benefit neither goal.

Section 3.2 (e) above discussed the argument in favour of grandfathering existing FLRs and their activities at the start of the new regime. Grandfathering must not, however, preclude a fundamental analysis of the right intensity of regulation. Decisions about where regulation is worthwhile from an economic perspective hinge upon the identification of market failure. In legal services, the key source of failure is not monopoly power, as in the case of certain utilities, but information problems – arising from the fact that consumers of certain legal services are infrequent purchasers and cannot evaluate the quality of any supplier's services *ex ante*.¹¹

However, economic analysis shows that, even in a world where some buyers are knowledgeable and others not, the former (if they are numerous enough and cannot be distinguished by suppliers and given special treatment) can police the market for all and thus confer an external benefit on the less well informed. In other words, lack of information is not enough to generate a market failure, still less one which would justify across-the-board intervention. Each market place must be examined separately, subject to there being strong prior indications that buyers of, say, barristers' services and of legal services for large corporates do not require protection while one-off idiosyncratic services purchased by households or SMEs, and often charged on a cost-plus basis, are more problematic.

This may suggest a *modus operandi* for determining how much to regulate as follows:

- The FLRs should be called on by the LSB to identify the market failures they find in their area of competence and to notify the LSB accordingly.

¹⁰ *Op. cit.*, pp. 7-10.

¹¹ Such services are described as being 'experience' rather than 'search' goods. See R. Baldwin, M. Cave and K. Malleson 'Regulating Legal Services: time for the big bang?' *Modern Law Review*, 67(5) 2004, pp. 787-811.

- The FLRs should simultaneously identify the appropriate remedies that will deal in a proportionate way with the market failures found and notify the LSB. The FLRs would offer an estimate of the direct and administrative cost (i.e. regulatees' costs) of regulation.
- The FLRs should be charged by the LSB to identify any regulatory actions or remedies that are needed to further LSB objectives.
- The LSB should have a general power to call on FLRs to investigate and report back on regulatory issues.
- The LSB, reviewing the position across the range of its responsibilities, should after consultation with FLRs and regulatees, issue a strategy statement which the FLR must apply.
- The FLRs should then implement the regulations subject to intervention by the LBS as described above.¹²
- The LSB should develop a system for measuring the effectiveness of the legal services regulatory regime in realising the LSBs statutory objectives.

In this process, regulatory proposals emerge from a fresh analysis of underlying problems. The starting point is a zero base, although the outcome can illuminatingly be compared with the *status quo ante*.

This system is calculated to avoid both under- and over-regulation. A key element is control of the FLRs' budgets. This should be done by the LSB on the basis of strategic and operating plans, including activity levels and efficiency targets submitted by the FLRs, and relying upon comparisons among them where appropriate. Given the small scale of individual regulatees, the latter are less likely to be able to launch an effective challenge against regulatory costs than the large, or even single, firms which confront a utility regulator. This is an example of how the two-tier structure of regulation (LSB and FLRs) can be utilised to block excessive regulation, based on an explicit duty on the LSB to control regulatory costs.

5.2 *Competition and dynamic efficiency*

There is nearly universal agreement that 'competition is the best regulator', provided that - in the present context - cutthroat competition among suppliers to gain business does not conflict with the 'public' values of the legal system. Effective competition also removes the need for costly regulatory measures.

Our proposals envisage that the competition authority, in the first instance the Office of Fair Trading, would play its familiar role in enforcing the Competition Act 1998 and other competition legislation.¹³ The OFT would be able, if necessary to undertake a market review of the legal services sector under the Enterprise Act 2002. This represents an important safeguard.

¹² This interactive and consultative process has something in common with the arrangements at European level for regulating telecommunications services – another sector with reasonable levels of competition.

¹³ As a corollary, the LSB would not have the powers with respect to competition legislation that are exercised concurrently with the OFT by certain network regulators.

However the LSB is envisaged to have a role which goes beyond this – one of promoting competition, and this objective should be carried down to the FLRs, with the dual aim of promoting innovation over time and of cutting regulation (We anticipate that the LSB and OFT will dual operate an MoU to avoid dual tracking of competition issues.

How this can be done in practice will vary from activity to activity and FLR to FLR. The discussion above suggested that in the provision of legal services the chief problems requiring regulatory intervention arise from informational problems on the part of end-users.

Broadly speaking, two types of remedies are commonly adopted to deal with these problems:

- End-users are given the information to make rational decisions, recognising that some of them will still be disappointed in the outcome.
- Exclusionary measures are taken to prevent the participation in the market of suppliers who are considered likely to provide poor quality services or (less frequently) to charge excessive prices.

Examples of measures of the first sort are allowing suppliers to advertise prices or other distinctions, requirements on them to specify charges in advance and so on.

Examples of measures of the second sort (some of them historical) are restrictions on entry into the provision of legal services except by persons with specified qualifications; prohibitions on the provision of services by employed solicitors; restrictions on advertising which have the effect of impeding entry; and restrictions on business structures.

It is widely recognised that measures of the first sort, if they work, are to be preferred, and it is widely acknowledged that some measures of the second sort have historically served the interests of permitted producers rather better than the interests of consumers. Indeed, Clementi proposes to eliminate many of the surviving measures of this sort.

There may, however, be cases where the consumer information problem is so widespread and intractable that restriction on access to the market can be justified. If an FLR identifies such a case, then in keeping with the LSB's obligation to promote competition, the FLR should justify its proposed remedy exceptionally to the LSB. In any event it should also set out any steps it proposes to take to improve the efficiency of information in the market place.

5.3 *Summary*

The creation of the new regime creates unparalleled opportunities to review and streamline economic regulation. The substantive task of such a review is not undertaken here but our recommended process involves:

- The clear delineation of an effective distribution of labour among LSB, FLRs and regulated entities.

- Use of the LSR/FLR regime to design incentive systems which counteract tendencies towards redundant and ineffective regulation and focus instead on a *de novo* analysis of market failure (or other obstacles to the proper operation of the legal system) and identification of areas where intervention is proportionate.
- The development of competition to the greatest possible extent over time as an alternative to regulation.

6. **Conclusions**

Much of the above discussion reviews issues rather than argues for specific recommendations. On some points, however, the weight of argument favours particular options. There seem strong cases for the following (non-exhaustive) list of suggestions:

1. The LSB should be given statutory objectives but not the FLRs (Para 1.1).
2. The LSB should work to three statutory objectives:
 - Maintaining confidence in the legal system and the rule of law.
 - Protecting and promoting the interests of users of legal services.
 - Ensuring that regulation is cost effective and promotes competition (para. 1.1)
3. There should be an LSB duty to issue a written statement expanding on its statutory objectives and stating how these will be achieved (para. 1.2).
4. It should be provided in law that day to day regulation will be delegated to FLRs (para. 1.3.1).
5. It should be provided that the LSB shall agree MoUs with the FLRs and that there be an informal process of dispute resolution involving a panel set-up by the Office of Fair Trading with a judge as a member (para. 1.3.1).
6. The LSB should have a reserve power to regulate service providers directly but only on the meeting of certain statutory conditions (paras. 1.3.2; 3.1.2).
7. LSB board members should be appointed by the Secretary of State (para .2.2.1).
8. Representatives of FLRs should not be appointed as members of the LSB board (para. 2.2.1).
9. The LSB's fees and charges should be independently reviewed by a government agency to ensure cost-effective regulation (para. 2.2.1).
10. The LSB should produce Annual Reports, appear before Select Committees and be subject to the Ombudsman's Jurisdiction (para. 2.2.1).
11. The LSB should hold an annual public meeting (para. 2.2.2).
12. The LSB should be obliged to issue a public consultation document before producing statements of general, regulatory policy (para. 2.2).
13. The LSB should have to give regulatees notice, opportunities to act and reasonable consultation before taking enforcement actions (paras. 2.2; 3.6.1).
14. The LSB should have to consult FLRs before issuing general statements of policy (para. 2.2).

15. The LSB should have to accompany binding rules and directions with a statement of conformity with statutory objectives (para. 2.2.2).
16. The scope of the regulatory regime should be set out in statute and secondary legislation with the LSB investigating regulatory gaps and needs for change. The LSB should advise the Secretary of State on amending legislation (para. 3.3.1).
17. The LSB should not have a power to compel an FLR to regulate a particular activity or group of providers (para. 3.1.2).
18. The LSB should have powers to approve the FLRs as regulators of alternative business structures as well as any proposed arrangements for particular ABS packages (para. 3.1.3).
19. A system open to provider or service based regulation should be retained under the control of the LSB (para. 3.1.4).
20. Criteria for LSB approval of FLRs should be set out in statute and expanded by the LSB (para 3.2).
21. The LSB should have the power to approve FLR rules and amendments to these as well the power as to require rule changes (para. 3.3).
22. The LSB should have a general power to investigate that is less constrained than its power to regulate providers directly (para. 3.5).
23. The LSB should possess a full range of sanctions for potential use against FLRs or directly regulated providers (para. 3.3.6).
24. LSB sanctions should include powers to suspend licences, fine, adjust levies, name and shame and operate undertakings agreements (para. 3.6.2).
25. The LSB should be empowered to proceed against FLRs in disciplinary cases where there is undue leniency (para. 3.6.2).
26. LSB disciplinary decisions should be appealable to an independent body (para. 3.6.4).
27. The OLC should be separately staffed and branded but work towards objectives set by the LSB (para. 3.7.1).
28. The LSB should supervise the OLC on systemic and policy issues but not on individual complaints (para. 3.7.1).
29. The OLC chair should be appointed by the LSB with the concurrence of the judiciary and key stakeholders (para. 3.7.1).
30. The OLC should refer conduct cases to the FLRs and, in cases involving conduct issues, should have a discretion to delegate the whole complaint (both conduct and service aspects) to the FLR (para. 3.7.3).

31. A super-complaints process should allow designated bodies to complain to the LSB about failures in the market (para. 3.7.4).
32. The LSB should be equipped with powers and resources that allow it to base its enforcement decisions on risk analyses (para. 4.4.4).
33. The LSB should have a role in controlling the FLRs' costs (para. 5.1.1).
34. The LSB should develop and apply a system for measuring regulatory burdens at all levels of control within the regulatory regime (para. 5.1.1).
35. The FLRs should be called upon by the LSB to identify market failures and potential remedies and to notify the LSB regarding these so that the LSB can evaluate the regulatory issues involved and issue a strategy statement which the FLRs must apply (para. 5.1.2).
36. The LSB should have a general power to instruct the FLRs to investigate regulatory issues and report back to the LSB (para. 5.1.2).
37. The LSB should develop a system for measuring the effectiveness of the regulatory regime in realising the LSB's statutory objectives (para. 5.1.2.).
38. Where any FLR proposes to restrict access to any market it should be obliged to make a case to the LSB for doing so (para. 5.2.).

Appendix 1

The Powers and Functions of Other Regulators Overseeing Self Regulatory and/or Professional Bodies

UK examples

Financial Reporting Council

The Financial Reporting Council, through its operating bodies, has a wide range of powers. These are mainly statutory powers granted by delegation from the Secretary of State directly to both the Council and the Operational Boards.

However, some self regulatory elements remain. In particular, the FRC has no statutory powers to perform the following functions:

- General independent oversight of the regulation of the accountancy profession by the professional bodies.
- Monitoring and maintaining the Combined Code on Corporate Governance.
- Addressing unsatisfactory or conflicting interpretations of accounting standards.

In each case, the professional bodies have agreed to comply with the FRC's recommendations on these issues. The Listing Rules also require companies to report on their compliance with the Combined Code, and the FSA and FRC have agreed an MOU on their respective roles in this area.

The FRC's objectives are to promote:

- High quality corporate reporting.
- High quality auditing.
- High standards of corporate governance.
- The integrity, competence and transparency of the accountancy profession.
- The FRC's effectiveness as a unified independent regulator.

Its main functions are:

- Oversight of the regulatory activities of professional bodies.
- Statutory oversight and regulation of auditors.
- Setting, monitoring and enforcing accounting and auditing standards.
- Independent investigation and discipline scheme for public interest cases.
- Promotion of high standards of corporate governance.

The main powers and functions of the FRC and its Operating Boards are:

- Authorisation of professional bodies to act as supervisory bodies and/or to offer a recognised professional qualification (Professional Oversight Board for Accountancy (POBA))

- Continuing oversight and monitoring of professional bodies and making recommendations on improvements. As noted, this function is not supported by statutory powers. Monitoring is planned to occur through cyclical investigation and testing of the bodies. Aspects reviewed include practices on: education, training, continuing professional development standards; ethical matters (except those which are the responsibility of the Auditing Practices Board); professional conduct and discipline; and registration and monitoring.
- Monitoring the audit quality of economically significant entities (Audit Investigation Unit of POBA).
- Standard setting including: issuing standards and guidance on financial accounting and corporate reporting (Accounting Standards Board); issuing standards and guidance on the performance of external audit and other assurance services provided by accountants, and the independence, objectivity and integrity of external auditors and providers of assurance services (i.e. other activities which result in published reports or other output, which is relied upon in the operation of financial markets). (Auditing Practices Board, which has taken over these functions from the professional bodies).
- Monitoring and investigation: the Financial Reporting Review Panel ensures that the financial information provided by public and large private companies complies with the relevant reporting requirements. It operates on a proactive basis, initiating investigations. It ensures that cases considered by it are brought to the attention of relevant regulatory bodies for those bodies to determine whether disciplinary or other sanctions should be applied. It cooperates with the Financial Services Authority in performing this role.
- Disciplinary powers: the Accountancy Investigation and Discipline Board has powers to investigate the conduct of members or member firms of the professional accountancy bodies and can take disciplinary action in public interest cases. There is a right of appeal to an independent Tribunal.

The regulatory bodies are under duties to cooperate with the FRC and Operating Boards in the performance of their regulatory functions.

Commission for Healthcare Regulatory Excellence (CHRE)

The CHRE's objectives are to:

- Promote the interests of the public and patients in relation to regulating healthcare Professions.
- Promote best practice in regulating healthcare professions.
- Develop principles for good, professionally-led regulation of healthcare professions.
- Promote co-operation between regulators and other organisations.

Its main powers are:

- General power to do anything which appears to it to be necessary or expedient in the performance of its functions, including: comparing the performance of different regulators; and recommending changes in the way regulators carry out their work.¹⁴
- Standard setting: power to recommend that a regulator makes rules or changes its rules if it feels that it is necessary to protect the public.¹⁵ In certain cases, it also has the power to issue directions requiring the regulatory bodies to make rules if it considers this is necessary to protect the public. In issuing directions, the regulatory body must be consulted, and the directions must first be laid before Parliament before they come into effect.
- Monitoring and investigations: general power to investigate and report on how regulators carry out their work; power to investigate individuals, as long as the individuals are not currently subject to disciplinary proceedings, or an allegation has been made which could result in such proceedings. It also oversees the complaints processes of regulatory bodies.
- Disciplinary processes: the CHRE can refer 'fitness to practise' decisions to the High Court if it considers that the regulator's decision is too lenient and that it is necessary to protect the public. This power has been used, but the 5th Shipman inquiry noted that there is some legal uncertainty as to the scope of the power. Care should therefore be taken in drafting any similar provision for the LSB.

Note that regulators are under a duty to cooperate with the CHRE in the performance of their regulatory functions.

The Office of Fair Trading

The OFT has the power to approve self regulatory codes of practice. This power existed under the Fair Trading Act 1973 but was widely accepted to be ineffective at enabling consumers to identify businesses employing best practices or to encourage businesses to raise their standards of consumer service. The Enterprise Act gives the OFT enhanced powers to approve self regulatory codes, and the OFT has adopted a new approach and procedure for approvals.

The Consumer Codes Approval Scheme consists of two stages. Code sponsors are required to complete Stage One by making a promise that their code meets the core criteria in principle. Stage Two requires them to demonstrate, with evidence, that their codes are effective in meeting those criteria. The OFT will only endorse and promote the code once its effectiveness has been demonstrated.

The OFT is required to publish, and has published, guidance on its core criteria and on implementation of the scheme.¹⁶

¹⁴ National Health Service Reform and Healthcare Professions Act 2002, s.26.

¹⁵ NHSR&HPA s.27.

¹⁶ OFT, *Consumer Codes Approval Scheme: Core Criteria and Guidance*, (OFT March 2004); OFT, *Consumer Codes Approval Scheme* (OFT, March 2004).

The core criteria cover a number of issues. Requirements include:

- Code sponsors to demonstrate that they have significant influence over Code members, that the Code will be mandatory and members are willing to accept its provisions.
- That the Code sponsors have adequate financial resources.
- Consultation with bodies representing consumers, enforcement bodies and advisory services in preparing the code and in monitoring its operation.
- Content of the Code. It must have provisions dealing with: consumer concerns and undesirable trade practices in the sector; staff awareness and training; clear and truthful marketing and advertising; clear and adequate pre-contractual information and clear and fair contract terms and conditions; high pressure selling; cancellation provisions and protection of prepayments and deposits; adequate after sales service; additional measures to help poor or vulnerable consumers.
- Complaints: processes for dealing with complaints must be speedy, responsive, user-friendly and accessible processes.

The Financial Services Authority

The Financial Services Authority oversees the regulatory activities of Lloyds and the recognised investment exchanges. It also oversees the regulatory activities of designated professional bodies (principally the legal and accounting professions) so far as they relate to the regulation of their members' carrying out designated investment business.

With respect to each body, it has the power to issue directions with which the regulatory bodies must comply.

Lloyds

The FSA has the power to issue directions to the Council directly or the Society or both. Directions may be given in relation to the exercise of a specific power, or its powers generally, with a view to achieving, or in support of a specified objective. The FSA also has the power to issue directions directly to market participants.

Designated professional bodies

Members of designated professional bodies are exempt from the requirement to obtain authorisation from the FSA before carrying on designated investment business. In order for this exemption to be given, the FSA has to approve the rules of the professional body in so far as they apply to the conduct of regulated activities. It has a duty to monitor the way that regulation is conducted by those professional bodies.¹⁷ Finally the FSA has the power to issue directions to remove the exemption either from the professional body as a whole, or from a particular firm.¹⁸

¹⁷ FSMA s.325.

¹⁸ FSMA s.328.

Recognised investment exchanges and clearing houses

The FSA has the power to direct the body to take specified steps, including altering its rules or suspending or discontinuing such of its operations as may be specified. Directions may be issued where the body has failed or is likely to fail, to satisfy the recognition requirements or any other obligation imposed by the FSA or under the Act.¹⁹ Directions are enforceable by injunction (England and Wales) or an order for specific performance (Scotland).²⁰

The former Securities and Investments Board

The Securities and Investments Board was a company limited by guarantee which was delegated powers under the Financial Services Act 1986. It had the powers to recognise self regulatory organisations as regulators of investment business, with the effect that members of the SROs received the necessary authorisation under the Act. SIB also had the power to issue authorisations to individual firms directly, which it was then responsible for regulating. In practice, SIB undertook very little direct regulation; most was performed by the SROs.

In the initial 1986 Act, SIB had the power to recognise SROs only if their rules provided a level of investor protection that was equivalent to that provided by SIB's own rule book. This led to the formation of highly detailed rules by both SIB and the SROs, which for a range of reasons were subject to frequent change. There were in fact a number of difficulties in making the two tier system work. These were:

- The close linkage between SIB and the SROs' rules.
- SIB's lack of powers to direct the SROs to act.
- SIB's only sanction over the SROs was derecognition.

In 1989 legislative amendments were introduced to enable SIB to issue statements of principle and to designate certain rules as applying directly to authorised persons. The criteria for recognition was also altered. The SROs' rules now had to provide an 'adequate' level of investor protection, rather than one 'equivalent to that provided by SIB's rules.

These changes enabled SIB to formulate 10 Principles, which provided the framework for the rules of SIB and the SROs, and to issue 40 Core Rules. These rules had to be incorporated into the SROs' rulebooks, but they could elaborate on them or not as they saw fit. They also could develop additional rules as appropriate for their members.

However, SIB's continuing lack of powers to direct the SROs to act in other aspects of their regulatory functions made it very difficult for SIB to address system-wide problems and clear failings in the SROs. This was evidenced in the pensions misselling episode. Eventually SIB managed to initiate the review, but its lack of direct powers meant at the very least that the Review got off to a far slower start than it would have done otherwise. Whilst public and political expectation was that SIB should act and take a lead, in practice it did not have the powers to do so.

Weaknesses were also evident in SIB's lack of powers to address regulatory failings on the part of some of the recognised exchanges.

¹⁹ FSMA s. 296(1) and (2).

²⁰ FSMA s.296(3).

It is worth noting that the FSA's powers over the exchanges have been enhanced in the light of experience under the 1986 Act.

Practice overseas: regulation of the legal profession

Regulation of the legal profession in Australia

In Victoria, Australia, the Legal Services Board is responsible for setting overall policy and all non-disciplinary functions within the system. The Legal Services Commissioner acts as a single point of entry for all complaints into the regulatory system but is not responsible for handling individual complaints. Professional associations continue to be involved in the development of conduct rules for the professions and disciplinary rulings.

In New South Wales, Australia, the Legal Professional Advisory Council reviews the activities of the professional bodies. Its primary functions are to keep the structure and functions of the legal profession under review and to make reports and recommendations to the Attorney General. Its remit includes the review of the professional standards, advertising and the general regulation of the legal profession and it can also be asked by the Attorney General of NSW to review particular issues or areas. The Council also has specific powers to refer any regulation or proposed regulation imposes restrictive or anti-competitive practices which are not in the public interest.

Regulation of the legal profession in Ireland

The Competition Authority issued a report on the legal profession in February 2005, *Study of Competition in Legal Services*. Consultation on the study ends on 30th June 2005.

The Authority recommends the establishment of an Independent Legal Services Commission. It proposes that the Commission be independent, with a majority of non-lawyer members. This body would take responsibility for regulating the legal profession as a whole. It would have as its objectives the facilitation of the administration of justice, the promotion of competition and the safeguarding of the public interest.

Two models are proposed, which shadow those of the initial Clementi proposals in the UK.

In Model A, the Legal Services Commission would exercise all the regulatory powers and responsibilities currently exercised by the Law Society, the Bar Council and King's Inns.

In Model B, while the Legal Services Commission would have overall responsibility for the regulation of legal services, it would delegate many regulatory functions to existing and possibly new self-regulatory bodies. These self-regulatory bodies would not, however, be permitted to exercise representative functions.

Regulation of the legal profession in Canada

This is currently still a self regulatory model, organized on a state basis.

Practice overseas: regulation of the accountancy profession

Regulation of the accountancy profession in Australia

The statutory Australian Financial Reporting Council is responsible for providing broad oversight of the process for setting accounting and auditing standards as well as monitoring the effectiveness of auditor independence requirements in Australia and giving the Minister reports and advice on these matters. It has powers to appoint members of the two main professional bodies (other than the Chairmen), approve their management and budget plans and their broad strategic direction, and give directions, advice or feedback on matters of general policy and on their procedures.

Regulation of the accountancy profession in Canada

The Canadian Public Accountability Board was established in October 2002. It oversees the inspection of auditors of public companies, the auditor independence rules and the quality control requirements for firms auditing public companies. It is a voluntary body, but the Securities Commission will only accept audits from firms with CPAB approval.

The CPAB sets standards which firms have agree with comply with, and it can impose sanctions directly on auditors.

Regulation of the accountancy profession in Ireland

Companies (Auditing and Accounting) Act, 2003 provides for establishment of the Irish Auditing and Accounting Supervisory Authority (IAASA). Its function is the supervision of the regulatory functions of the recognised accountancy bodies and other prescribed accountancy bodies.

The stated objects of the IAASA are as follows:-

- To supervise how the prescribed accountancy bodies regulate and monitor their members.
- To promote adherence to high professional standards in the auditing and accountancy profession.
- To monitor whether the accounts of companies comply with the Companies Acts.
- To act as a specialist source of advice to the Minister on auditing and accounting matters.

The IAASA has a wide range of functions including:

- Granting recognition to accountancy bodies.
- Approving and prescribing the standards of professional conduct for their members.
- Undertaking investigations into possible breaches of standards.
- Imposing sanctions where appropriate.

The IAASA has the power to intervene in the disciplinary process of prescribed accountancy bodies. Where the IAASA is not satisfied that the body in question has complied with the investigation and disciplinary procedures already approved, it has the power to:

- Annul all or part of a decision of such body.

- To direct that body to conduct further investigation or a fresh investigation.
- To fine the body in question for not complying with the approved standards and procedures.

There is a right of appeal to the High Court.

The IAASA also has the power to examine the accounts of all public companies and private companies whose balance sheet total exceeds €25,000,000 and whose turnover exceeds €50,000,000 to establish whether they are in compliance with the Companies Acts. If it appears to the IAASA that there is an issue relating to compliance, it will have the power to send a notice to the directors of the relevant company specifying the relevant compliance issue, stipulating a period within which the company must provide an explanation or prepare revised accounts. Where a company fails to comply with such a request, the IAASA can apply to the High Court for a declaration of non-compliance and an order for the appropriate remedy, including an order for costs. The Registrar of Companies is entitled to receive a copy of any such order.