



**Legal Services Policy Institute**

**DISCUSSION PAPER**

**EXTERNAL OWNERSHIP AND INVESTMENT**

**Issues and Challenges**

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# EXTERNAL OWNERSHIP AND INVESTMENT

## Issues and Challenges

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### 1. Introduction

#### 1.1 Background

The Legal Services Act 2007 establishes a framework for the licensing of 'alternative business structures' (ABSs). These will allow ownership and investment interests to be held by people or businesses other than qualified lawyers. The precise regulatory provisions are yet to be put in place, but those who wish to take advantage of the new structures are already preparing themselves and considering different mechanisms and arrangements to do so. Some of the strategic and business implications of ABSs were the subject of previous Institute papers, *Alternative business structures: something for everyone?*, published in November 2007<sup>1</sup>, and *The Legal Services Act 2007: Implications for the Bar's sources of work*, published in July 2008<sup>2</sup>.

The SRA has published its draft regulations for the transitional forerunner of ABSs, that is, legal disciplinary practices (LDPs) with up to 25% external ownership or investment<sup>3</sup>. The regulations for ABSs are not expected to be ready for some time. There is, accordingly, a necessary and unavoidable period of uncertainty for those who wish to create ABSs. However, that is also a period during which debate and exploration can take place with a view to informing and influencing those responsible for advising on and drafting the regulations.

In pursuance of its objectives, the Legal Services Policy Institute has established a Forum on external ownership and investment to offer that opportunity for debate, exploration and

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<sup>1</sup> The paper was an updated version of an article that first appeared in *New Law Journal* on 27 July 2007.

<sup>2</sup> A version of this paper was also published in *Counsel* in July 2008.

<sup>3</sup> Recognised Bodies Regulations 2009, available at: [www.sra.org.uk/documents/SRA/lisa/sra-recognised-bodies-regulations-2009-not-in-force.pdf](http://www.sra.org.uk/documents/SRA/lisa/sra-recognised-bodies-regulations-2009-not-in-force.pdf)

influence. Attendance is by invitation only, and discussions are conducted according to the 'Chatham House Rule'<sup>4</sup>. The Forum is chaired and facilitated by the Director of the Institute, and participants include representatives from Government, regulators, professional representative bodies, law firms, new entrants, intermediaries and suppliers of legal work, banking and private equity, and the insurance market.

This paper sets out to define and explore the prospective territory for debate at the Forum and in the wider marketplace. The paper represents a mix of forward-looking themes that anticipate the granting of ABS licences, as well as some shorter-term practical matters that arise during the 'transitional' period. However, the Institute does not wish to limit the range of topics for discussion.

## 1.2 Scope of this Discussion Paper

The principal purposes of this paper are, first, to provide a briefing of the relevant provisions of the Legal Services Act 2007 and, second, to set out and explore in outline the issues and challenges that the Institute has identified in connection with ABSs and 'external' ownership and investment (these are summarised as a series of questions at the end of the paper). As such, it will also provide a preliminary guide to the possible scope of the Forum's discussions. The paper is organised as follows:

- (1) Policy, regulation and ethics, including the policy and regulatory framework, ethical implications, and mandatory requirements, of the Legal Services Act, in relation to LDPs and ABSs.
- (2) Ownership and investment, including fitness to own, the nature and degree of 'external' ownership, and sources and methods of financing.
- (3) Service combination, including strategy, separate businesses, abuse of dominant position, and the pursuit of higher-risk objectives.
- (4) Service delivery, including competence and quality, conflicts of interest, resourcing, and intermediaries.
- (5) Management, including the role of lawyers and management competence.
- (6) Education.
- (7) Special and 'low-risk' bodies.
- (8) Risk, complaints and insurance.
- (9) Orderly exits.

The Institute would welcome suggestions for other issues that participants and other interested parties would wish the Forum to explore.

In the interests of brevity and readability, there is some paraphrasing in the paper (which is not intended to be exhaustive in its coverage). Readers should also bear in mind that the term 'manager' in the Act is not used in its colloquial sense but rather to mean a partner, a member of a limited liability partnership or a director of a limited company (s. 207(1)).

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<sup>4</sup> "When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed."

## 2. Policy, Regulation and Ethics

### 2.1 Policy and the Legal Services Act 2007

The Legal Services Act 2007 sets out some overarching ‘regulatory objectives’ in s. 1(1), including protecting and promoting the public interest and the interests of consumers (as well as increasing public understanding of rights and duties), supporting the rule of law and improving access to justice, and promoting competition among lawyers within the context of an independent, strong, diverse and effective legal profession. The Act also requires the promotion and maintenance of ‘professional principles’ (s. 1(3)) relating to acting with independence and integrity and in the best interests of clients while keeping their affairs confidential, maintaining proper standards of work, and the duty to the court to act independently in the interests of justice.

These objectives and principles set some broad policy objectives for the new framework. However, should there be a sharper distinction between:

- (a) promoting, preserving and protecting some aspects of legal services as a *public good* – as ends in themselves for the benefit of society (such as maintenance of the rule of law, the effective and efficient administration of justice, and access to justice); and
- (b) removing, reducing or restricting the effects of existing or anticipated *market failures* (such as entry barriers, availability of legal services, asymmetry of information, unequal bargaining power, and predatory pricing)?

There has been a running sub-text in the Clementi Review, the White Paper and the Act itself that a ‘marketplace’ for legal services exists and that this should be liberalised and, indeed, forced to act more overtly in accordance with market principles<sup>5</sup>. However, the introduction of market principles – and regulation to avoid market failures – must surely nevertheless be shown to be sufficiently sensitive to the public good dimensions, and explicitly address the question of whether all aspects of ‘public good’ legal services are susceptible to the application of market principles. To put it another way: Is there (and should there be) a ‘market’ for the rule of law, the effective and efficient administration of justice, or access to justice?

This paper seeks to avoid conflating ‘access to justice’ and ‘access to legal services’. The former is taken to refer to the ability of a citizen to pursue a legal remedy or defend themselves against criminal charges or civil claims where, on any reasonable view, legal representation ought to be available to them (and in some cases even where they would not be otherwise able to afford it). Any denial of that representation could lead to someone being unnecessarily or unjustifiably deprived of assets, outcomes or liberty and, in the public interest, society requires that access to justice should be as broadly and reasonably available as possible. The latter refers to a broader type of access where legal services are both necessary (in the access to justice sense) as well as desirable rather than critical and, in this broader sense, the result of a choice made by the citizen (such as moving house, making a will, entering into a contract, making tax-driven dispositions of property). There may well

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<sup>5</sup> We should probably pause to consider whether such a trend would now be as politically acceptable as it was during the gestation period of the Act, given the increased interest currently being shown in stronger regulation of the financial services ‘marketplace’ in the aftermath of perceived regulatory shortcomings.

be times when access to justice is compromised by an inability to access legal services (for example, where local legal advice is not available), but the two are not the same (for example, services may be available, but the citizen is denied access to justice by an inability to pay for them).

Perhaps it is justifiable to adopt a policy starting-point that a professional monopoly on the delivery and structures of legal services is a bad thing, and that the introduction of substitutes (whether as providers, services, products, methods, owners or investors) should be enabled and encouraged. It would then follow that some actual or potential 'market failures' should attract regulatory attention:

- (1) as 'enabling' intervention, for example, to:
  - (a) reduce or remove entry and exit barriers in the belief that this will encourage greater competition, increased output and lower prices (in effect, shifting income from producers to consumers);
  - (b) ensure continuity of service and of access to services, such as tolerating elements of cross-subsidy between services and client groups to encourage a broader range of provision or to discourage 'cherry-picking' and advice deserts; or
  - (c) encourage the rationalisation, consolidation or coordination of providers – particularly in circumstances where providers are predominantly small firms in a fragmented and geographically dispersed market and unlikely therefore to organise production and delivery as cost-effectively as an 'efficient' market<sup>6</sup>; and
- (2) as 'preventive' intervention, for example, to address:
  - (a) inadequacies or asymmetries of information (especially for irregular or expensive purchases such as house moves or wills);
  - (b) unequal bargaining power (for instance, between lawyer and client, or between law firms and a monopsony buyer such as the Legal Services Commission or volume buyers such as banks or insurance companies); this might be particularly acute in relation to vulnerable client groups such as the elderly, the young, or the disabled;
  - (c) predatory pricing by providers with a dominant or extensive market share with the intention of driving smaller providers out of the market;
  - (d) moral hazard arising from, say, 'excessive' use by some clients of legal aid services at the expense of taxpayers or of other services at the expense of a broad group of insured persons many of whom pay insurance premiums without making claims; or
  - (e) restrictions or distortions in the sources or availability of capital.

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<sup>6</sup> This was one of the themes explored in my inaugural lecture, *Legal services reforms: catalyst, cataclysm or catastrophe?* (2007)

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Just as no market will operate perfectly (thus requiring regulatory intervention), so no regulatory framework will work perfectly either. In taking action, regulators should presumably therefore compare the market and its costs and failings with regulation and its costs and failings<sup>7</sup>. Regulating in the public interest would be justified by a conclusion that the market would otherwise fail to deliver a publicly desirable outcome, and that regulatory intervention is justifiable and can be achieved at an acceptable cost. In turn, this suggests an agreed view – rather than competing conceptions – of what ‘the public interest’ is, as well as competence within the regulatory bodies to reach the correct judgement and adopt the best policies.

In the context of ABSs, such conclusions lead to some uncomfortable issues and challenges because:

- (i) the Act’s regulatory objectives potentially compete with each other: for example, the efficiency of ABS structures that might promote competition and the interests of consumers (s. 1(1)(d) and (e)) could easily conflict with the public interest and access to justice (s. 1(1)(a) and (c)) if ABSs reduce the number of, say, self-employed barristers and rural law firms; and
- (ii) ABSs will be of interest to varied and competing interest groups: for instance, new competitors with new methods of delivery – including achieving greater output at lower prices – will inevitably threaten more ‘traditional’ law firms, and might in the process be thought by some to jeopardise access to justice for certain consumers (particularly, perhaps, vulnerable clients who are in geographically remote areas and who do not have access to transport or the latest technology).

Against this policy background of competing claims for attention and justification, and potentially conflicting interests, an important first step arises: in order to establish sound and sustainable foundations for external ownership and investment, and a successful regulatory framework for ABSs, it is first necessary to articulate overarching objectives in relation to ‘public good’ and public interest outcomes to be achieved, and market failures to be addressed. We should explore whether (and by when) this articulation can be completed.

## 2.2 Regulatory Framework

In his review of the regulatory framework of legal services, Sir David Clementi took the view that there was little variation in the type of business structures through which consumers could access legal services. He did, however, conclude that it would be prudent first to enable the creation of LDPs. In his conception, these new structures could include lawyers from different professional backgrounds (who would always be in a majority of owners), as well as non-lawyers who enhanced the services of the law practice (rather than providing other services to the public) and outside owners who met a ‘fit to own’ test<sup>8</sup>. In Sir David’s view, multidisciplinary practices (MDPs) should only be contemplated “if at some subsequent juncture the regulatory authorities considered that sufficient safeguards

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<sup>7</sup> In the absence of such an assessment, it is difficult to see how a regulator could justifiably claim to be introducing ‘risk-based and proportionate’ responses.

<sup>8</sup> LDPs are considered in further detail in paragraph 2.3 below.

could be put in place” (*Review of the Regulatory Framework for Legal Services in England and Wales*, Final Report 2004, Chapter F, para 104).

The Department for Constitutional Affairs took a broader view, and felt that the regulatory framework should be changed to accomplish the following objectives (*The Future of Legal Services: Putting Consumers First* (2005), para 3.2):

- removing barriers to make it easier for new providers to enter the market through alternative business structures, so stimulating competition and innovation;
- efficiencies resulting in reductions in costs that are passed on to consumers;
- encouraging one-stop-shops which deliver packages of legal and other services that better meet consumers’ needs and provide greater convenience for them;
- allowing access to external investment, as well as permitting different types of lawyers, and lawyers and non-lawyers, to work together on an equal footing in ways that enable firms to upgrade their infrastructure and generate fresh ideas about providing services in consumer-friendly ways.

These objectives overtly address market failures; arguably, when addressed, they all contribute to achieving the public good of access to justice – though this appears to be a secondary objective. Indeed, as pointed out in paragraph 2.2 above, possible conflicts among objectives could result in access to justice being undermined rather than promoted. However, if access to justice were a primary objective – and more particularly, if we identified those clients groups for whom, and the relevant legal services to which, better access was required – there might be differential targeting of regulatory intervention to achieve more specific access goals. In other words, simply addressing market failures (even as a matter of principle) will not necessarily or inevitably achieve desirable public outcomes without better articulation and clarity of public good objectives. On this view, the ‘important first step’ identified at the end of paragraph 2.1 above has not yet been taken.

In achieving the goals set out above, the Government envisaged that a number of policy decisions would still be left to the oversight of the new Legal Services Board, including such issues as:

- (a) whether the services provided by some ABSs should require a lawyer majority or a certain level of lawyer control (*The Future of Legal Services: Putting Consumers First* (2005), para 6.5);
- (b) any limits on the extent of external investment in ABSs according to the type of business and the need to secure the regulatory objectives (*The Future of Legal Services: Putting Consumers First* (2005), para 6.7); and
- (c) dealing with conflicts of interest, including setting a percentage level of ownership at which a conflict is not considered significant (*The Future of Legal Services: Putting Consumers First* (2005), para 6.9).

These issues are indeed carried over into the framework of the Legal Services Act, and are considered further in this paper in, respectively, paragraphs 3.3, 2.6(7) and 5.2. However, the overall tenor of the legislation – as the Clementi Report envisaged and recommended – is permissive.

The proposals for LDPs were adopted (see further paragraph 2.3 below). MDPs will become possible as one manifestation of ABSs. Given that LDPs will be permitted from 2009 and that ABSs will not be licensed until probably at least 2011 (cf. paragraph 2.4 below), the Government will effectively have introduced a transitional and 'testing' period before MDPs will be allowed under the ABS framework. Whether this testing period will prove adequate – and, indeed, whether it will be as long or as rigorous as Sir David Clementi intended – remains to be seen.

### 2.3 Recognition of LDPs and Entity Regulation

The Clementi Report's notion of LDPs appears in Schedule 16 of the Legal Services Act. It is achieved by amendments to the Administration of Justice Act 1985, and in particular the insertion of a new s. 9A by Sch 16, para 82. The LDP is described in the Act as a 'legal services body' (s. 9A(1)), and the statutory structure is an extension of the provisions originally introduced to allow and recognise incorporated legal practices.

In essence, LDPs are of two types (both regulated by the Law Society through the Solicitors Regulation Authority):

- (a) Bodies that have 'mixed lawyer' ownership, that is, any combination of solicitors, barristers, legal executives, licensed conveyancers, and patent and trade mark attorneys. Because an ABS cannot be wholly owned by lawyers (cf. paragraph 2.6(5) below), this form of LDP will continue to exist even when the ABS licensing framework is operating.
- (b) Bodies that have both lawyer and non-lawyer ownership, where the non-lawyers could be:
  - (i) those currently employed in law firms as professional managers (eg a director of finance or human resources);
  - (ii) other professionals or service providers (eg consulting engineers, forensic accountants, nurses, counsellors);
  - (iii) support staff (eg secretarial and office staff); and
  - (iv) those who wish to invest in a firm (whether through the introduction of financial capital or of supporting technology and processes).

The language of the ABS legislation is such that these forms of LDPs will be required to become ABSs (cf. paragraph 2.6 below) and they are, therefore, transitional structures.

At least 75% of an LDP's managers must be legally qualified<sup>9</sup>, and at least 75% of its ownership and voting rights must be held or controlled by those so qualified (s. 9A(2)(a)-(c)). Further, non-lawyers with an interest must be managers (s. 9A(2)(d), which, given the definition of 'manager', means that a non-lawyer could not be merely a shareholder in an

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<sup>9</sup> For this purpose, 'legally qualified' means an authorised person (lawyer) who is an individual, a registered foreign lawyer, and a European lawyer practising under his or her own professional title in accordance with EC Directive 98/5, as well as certain bodies (s. 9A(6)).

incorporated practice having no direct responsibility in the business's activities), and must be approved by the SRA as 'suitable' to be managers (s. 9A(2)(e)). An LDP must have at least one manager who is a solicitor or registered European lawyer (s. 9A(4)<sup>10</sup>). Finally, an LDP will provide only legal services (cf. s. 9(1A), (1B), (1C) and (8)).

Following the lead from the legislation, LDPs become a reality through the SRA adapting and amending its 'recognised body' regulations (see footnote 3 above), which set out the requirements for recognition. However, the same Regulations apply to all law firms – whether LDPs or not – and they are therefore the principal vehicle through which the SRA is introducing entity regulation. The recognition of LDPs as recognised bodies is therefore just one facet of a broader approach to entity regulation.

There is, however, a residual issue of an LDP reverting to non-LDP status if, say, its only approved non-lawyer manager dies or leaves the firm. The need for a firm to 'switch' between two different recognition processes in these circumstances is recognised as unsatisfactory. However, it will need secondary legislation to resolve it.

## 2.4 Licensing of ABSs

The Legal Services Act refers to ABSs as 'licensed bodies' (s. 71). Licences may only be issued by licensing authorities. These authorities will be approved regulators (such as the Law Society, Bar Council, Council for Licensed Conveyancers) designated as such by the Lord Chancellor on the recommendation of the Legal Services Board<sup>11</sup>, and must propose licensing rules that are approved by the Board (Sch 10, para 1(2)).

The whole licensing framework therefore requires the Legal Services Board to be operational. Approved regulators will then apply to the Board to become a licensing authority (s. 74 and Sch 10, para 1). The Board has a duty in respect of each application to consult the OFT, the Consumer Panel, the Lord Chief Justice, and any other person or body it considers reasonable, each of whom can request further information before giving advice to the Board; the applicant regulator must be given a copy of any advice received by the Board and is entitled to make representations to the Board about it (Sch 10, paras 3-9). The Board has 12 months to reach a decision or, with the Lord Chancellor's consent, up to 16 months (Sch 10, para 13). The Lord Chancellor has a further 90 days within which to make or refuse an order approving the designation as a licensing authority (Sch 10, para 15).

A licensing authority can only be designated in respect of a reserved legal activity for which it is an approved regulator (Sch 10, para 1(3)(a)). Once designated, a licensing authority must prepare and publish a policy statement, approved by the Board, setting out how, in the exercise of its ABS licensing functions, it will comply with its s. 28 duty to promote the Act's regulatory objectives (s. 82). In issuing licences, a licensing authority must have regard to its policy statement (s. 82(5)), and it has a period of six months (extendable to no more than nine months) to make a decision on whether to issue a licence (Sch 11, para 2).

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<sup>10</sup> A manager can also be a 'qualifying body', under requirements set out in s. 9A(5)-(7).

<sup>11</sup> There is also provision for the Legal Services Board, acting in a different capacity, to be a licensing authority of 'last resort': see ss. 73 and 84(2), and Sch 12, para 1.

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Taking the total timetable into account, therefore, the maximum period that could be taken before an ABS licence might be issued would be 28 months from the time the Legal Services Board is ready to accept applications from approved regulators (16 for the designation of a licensing authority, three for the Lord Chancellor's approval, and nine for the determination of a licence application). There is clearly scope for this timetable to be shortened in reality, but much will depend on the readiness of the Board, and the expedition with which each of the Board, the Lord Chancellor and the new licensing authorities discharge their respective functions in the process.

Licensing rules must contain (s. 83(5)<sup>12</sup>):

- (a) 'qualification regulations' setting out the bodies to which the licensing authority proposes to issue licences;
- (b) provisions about how, in issuing licences, the licensing authority will take account of the regulatory objective of improving access to justice; it would seem to follow from this that if a licensing authority is not to be perceived as acting arbitrarily or inconsistently, then when it is minded to refuse or attach conditions to an ABS licence on the basis that access to justice would, in its view, be compromised, it should also be able to explain how it has defined markets, geographical areas, groups of consumers, and methods or volumes of supply, in order to determine whether or not, and the extent to which, access to justice has or might be affected; these considerations become more important in a world where, increasingly, access to legal work is controlled through larger institutions or providers (irrespective of the related challenges of referral fees for securing access);
- (c) arrangements for regulating the conduct of ABSs and their managers and employees (including rules relating to conduct, discipline and practice);
- (d) indemnity and compensation arrangements;
- (e) arrangements for preventing conflicts between the regulations of the licensing authority and those of other regulators; where an ABS could be regulated by more than one licensing authority, there is a need for the Legal Services Board to consider the extent to which it is prepared to allow – or even encourage – 'regulatory arbitrage' (that is, to permit licensing authorities to adopt different rules which might result in them being, or being perceived to be, lighter touch and less onerous in their requirements, better value for money, and so on); and
- (f) arrangements requiring the ABS to establish and maintain a complaints procedure.

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<sup>12</sup> Other mandatory provisions relating to the content of licensing rules include: form and determination of applications, and modification of licences (Sch 11, paras 1, 2, 3, 6 and 7); special bodies (Sch 11, para 8); management requirements (Sch 11, para 9); Heads of Legal Practice and of Finance & Administration (Sch 11, paras 11-14); practising address (Sch 11, para 15); reserved activities to be carried on only through someone entitled (Sch 11, para 16); compliance with regulatory arrangements (Sch 11, para 17); not employing disqualified employees (Sch 11, para 18); client accounts (Sch 11, para 20); fees and penalties (Sch 11, paras 21 and 22); and disqualification, and suspension or revocation of licences (Sch 11, paras 23, 24 and 26).

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## 2.5 Ethical Implications

The principal policy and philosophical objections to ABSs seem to have focused on matters of (actual or perceived) ethics and integrity. Concerns are often expressed about the potential for non-lawyer interference with lawyers' professional judgement, ethical conduct, and duty to the court. There have also been objections based on conflicts of interest, particularly between the duty to shareholders in an incorporated legal practice and the duty to clients or the court. Experience in other jurisdictions (such as New South Wales) suggests that a focus on ethical behaviour and 'education for compliance' with regulation could pay dividends<sup>13</sup>. Work commissioned by the Department for Constitutional Affairs also suggested that it is not the business structure that should be the principal cause for concern but rather the underlying incentives, and that 'traditional' structures and methods of practice involving only lawyers are just as likely to encourage unethical behaviour<sup>14</sup>.

The Legal Services Act 2007 establishes a framework for ABSs which, in its totality, addresses a number of ethical dimensions. The principal features include:

- (a) the regulatory objectives and professional principles, which the Legal Services Board, approved regulators, licensing authorities, ABSs and their officers must work to achieve and maintain (ss. 1, 3, 28, 82 and s. 91(1) and Sch 11, para 17(2)(b));
- (b) reserved legal activities being delivered only by those who are authorised to do so (Sch 11, para 16);
- (c) the appointment of an approved Head of Legal Practice (HoLP) who is entitled to deliver at least one of the reserved activities for which the ABS has a licence, and an obligation on that person to ensure that the ABS complies with the terms of its licence – and, indeed, to report any failure to the licensing authority (Sch 11, para 11 and s. 91(1));
- (d) statutory obligations on lawyers to comply with the rules of their professional regulator (s. 176) and on non-lawyers not to do anything which might cause a breach of those rules (s. 90), combined with an obligation on the ABS to have "suitable arrangements" in place to ensure compliance with these obligations (Sch 11, para 17) as well as the HoLP taking "all reasonable steps" to ensure compliance and to report any failures to the licensing authority (s. 91(3) and (4)); and
- (e) the approval of interests carrying rights of ownership or control that exceed a defined percentage (see further paragraph 2.6(7) below).

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<sup>13</sup> See Parker et al. (2008) *Assessing the impact of management-based regulation on NSW incorporated legal practices*, whose research found that law firms adopting 'appropriate management systems' as required by NSW legislation (and in particular following the ten management objectives and the self-assessment process established by the NSW Legal Services Commissioner, details of which are available at [www.lawlink.nsw.gov.au/lawlink/olsc/ll\\_olsc.nsf/pages/OLSC\\_ilp](http://www.lawlink.nsw.gov.au/lawlink/olsc/ll_olsc.nsf/pages/OLSC_ilp)) reduced their level of client complaints to a third of the rate existing before self-assessment.

<sup>14</sup> See Grout (2005) *The Clementi Report: Potential risks of external ownership and regulatory responses*; arguably, the collapse of confidence and of the financial system in the second half of 2008 – some would say in part because of distorting incentives to bankers – lends further weight to this proposition.

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The statutory framework is comprehensive and robust. The ethical reality of an ABS will rest with the behaviour of its owners, investors and staff, the integrity of its HoLP, and the effectiveness of regulatory oversight by its licensing authority and the Legal Services Board.

## 2.6 What the Legal Services Act 2007 allows (and does not)

The provisions of the Legal Services Act relating to ABSs and the licensing rules through which such entities will be created distinguish between what the rules 'must', 'must not' and 'may' contain or address.

In relation to the principal mandatory provisions:

- (1) An ABS cannot have only authorised persons (lawyers) as managers (Sch 11, para 10).
- (2) An ABS must deliver a reserved legal activity<sup>15</sup> (ss. 71(1), 85(1)(a) and 111(1), and Sch 11, paras 9(1) and (2) and 11(2)(a) and (3)(b)).

The new statutory framework therefore creates a regulatory gap. Non-lawyer-owned providers delivering reserved activities (possibly alongside non-reserved activities) must be licensed and regulated as ABSs, and lawyer-owned firms delivering non-reserved activities (whether or not alongside reserved activities) will be recognised and regulated by the Solicitors Regulation Authority (SRA) or other approved regulator. However, a non-lawyer-owned provider delivering non-reserved activities will not need (or be able) to be licensed or regulated under the Act. Further, it would not seem that the Legal Services Board's powers extend to such providers.

The Legal Services Board has a statutory obligation to promote competition in the provision of reserved legal activities and in non-reserved activities of the sort provided by lawyers (ss. 1(1)(e) and (2) and 3(2)). But it is then given powers only over approved regulators and licensing authorities (which in turn apply their powers to authorised persons) or in its own capacity as an approved regulator or licensing authority (similarly only over authorised persons). While the complaints ombudsman scheme will apply to non-reserved activities, the respondent must nevertheless be an authorised person (s. 128(1)).

From the point of view of protecting the interests of consumers (s. 1(d)), there appears to be a significant shortcoming in the legislation: their protection in relation to the purchase of what they perceive to be a 'legal service' (such as the drawing up of a will) will vary depending not on the product or service purchased (a will) but by the nature of the provider (an authorised person providing a non-reserved activity, or a non-authorised person providing an

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<sup>15</sup> This appears to be implicit rather than explicit and could, therefore, be open to interpretation and a contrary conclusion. The strongest argument appears to be that: (i) an ABS must have a Head of Legal Practice (Sch 11, para 11(2)(a)); (ii) the HoLP must be an authorised person in relation to at least one of the ABS's licensed activities (Sch 11, para 11(3)(b)); (iii) a licensed activity is a reserved legal activity (s. 111(1)); and therefore (iv) an ABS must of necessity carry on a reserved legal activity if it is to have a licence.

activity for which no authorisation is required). The replacement of a 'lawyer' approach to regulation with an 'entity' approach apparently still leaves a hole in relation to non-reserved services or products provided neither by a regulated lawyer nor a regulated entity.

The Legal Services Board is aware of this 'regulatory gap', and of its powers to recommend additions to the list of reserved activities. While there is undoubtedly some force in the consumer view that supports comparability of treatment in relation to any given legal 'service' experienced by a client, nevertheless in a new regulatory framework based in part on not extending 'professional monopolies', it remains to be seen how high a priority the Board's consideration of this regulatory gap will attract. A review of non-reserved activities should be encouraged. However, even when they are examined, any review will have to address a cost-benefit analysis of extending regulation through reserved activities as against allowing the current 'mischief' to continue.

- (3) Reserved legal activities in respect of which an ABS has a licence must be delivered by a person (lawyer) who is authorised for that activity (Sch 11, para 16 and ss. 111(1) and 18).
- (4) An ABS licence must only be granted to a 'licensable body', that is, a body of which either a non-authorised person (non-lawyer) or another entity is a manager or in which such a person or entity has an ownership or voting interest (s. 72). Where another entity is involved, non-authorised persons must be able to exercise or control the exercise of at least 10% of the voting rights in that entity.
- (5) An ABS must have:
  - (a) at least one non-authorised person as a manager, shareholder or controller of voting rights (s. 72, and see sub-paragraph (4) above), and cannot therefore be wholly-owned by lawyers (Sch 11, para 10);
  - (b) at least one manager who is an authorised person for the reserved legal activity which the ABS is licensed to provide (Sch 11, para 9); given that, for an incorporated practice, 'manager' means director rather than shareholder, an incorporated ABS could therefore be wholly owned by non-lawyers<sup>16</sup>;
  - (c) a Head of Legal Practice (HoLP) who must be an authorised person in relation to at least one of the reserved legal activities provided by the ABS, and a Head of Finance and Administration (HoFA), both of whom must be approved by the licensing authority as 'fit and proper' to hold their positions, and both of whom carry explicit duties to ensure that the ABS complies with the Act and the terms of its licence and have positive obligations to report non-compliance to the licensing authority (ss. 91 and 92, and Sch 11, paras 11 and 13);

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<sup>16</sup> Cf. paragraphs 2.2 above and 3.3 below.

- (d) “suitable arrangements” to ensure (Sch 11, para 17):
  - (i) compliance with s. 176 (duty of authorised persons, and their managers or employees, to act in accordance with the requirements of their professional regulator);
  - (ii) compliance with s. 90 (non-authorised persons not to do anything which causes or substantially contributes to a breach of the s. 176 duty by the ABS or by employees or managers who are authorised persons);
  - (iii) maintenance of the professional principles in s. 1(3).
- (6) An ABS must not have a manager, HoLP, HoFA or employee who has been disqualified under the Act (Sch 11, paras 9, 11(3)(c), 13(3)(b) and 18).
- (7) Where a non-authorised person holds a ‘restricted interest’ in an ABS, that interest must be approved by the licensing authority (the conditions for approval are addressed in paragraph 3.2 below). Restricted interests can be either ‘material’ or ‘controlled’:
  - (a) A material interest exists where a person (or their associates<sup>17</sup>, either separately or together) holds 10% or more of the shares or voting rights in the ABS or its parent, or is able to exercise significant influence over the management of the ABS or its parent through a shareholding or entitlement to exercise, or control the exercise, of voting rights (Sch 13, paras 2 and 3). A licensing authority may, however, specify a lower percentage than 10% in its licensing rules (Sch 13, para 3(2)(a)).
  - (b) Controlled interests are similar, in that a person (or their associates, either separately or together) will hold at least a specified percentage of the shares or voting rights in the ABS or its parent (Sch 13, para 4: there is no ‘significant management influence’ provision for controlled interests). The specified percentage must be greater than 10% or, if the licensing authority has specified a lower percentage than 10% in relation to restricted interests, greater than that lower percentage (Sch 13, para 4(5)).

Finally, the Act includes enforcement provisions which encompass requests for information (s. 93), financial penalties (s. 95), referral of a manager, employee, HoLP or HoFA to their regulator (s. 98), disqualification from being a manager, employee, HoLP or HoFA in an ABS (s. 99), suspension or revocation of the ABS licence (s. 101), and intervention (s. 102 and Sch 14), as well as restrictions on or divestiture of ownership or voting interests (Sch 13, paras 41-45). A licensing authority must also maintain a public register of ABSs (s. 87).

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<sup>17</sup> The term ‘associate’ is broadly defined in Sch 11, para 5 to extend to immediate family, employees, business partners, directors, subsidiaries, share options, voting agreements, etc.

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### 3. Ownership and Investment

#### 3.1 The meaning of 'external' ownership

The debate about 'alternative' business structures and 'external' ownership and investment is often distorted by a failure to understand the nature of the alternative and externality in question. Much of the argument assumes that new forms of ownership and investment will be external to the firm. However, the restriction being addressed by the legislation is the requirement that ownership should be vested in qualified lawyers. As such, non-lawyer employees already within a law firm – and in that sense 'internal' rather than 'external' – become 'alternative' owners and investors just as much as those who are truly and fully on the outside of the firm. It would be unfortunate if the use of somewhat misleading terminology clouded the consideration and resolution of issues and priorities.

Of course, the first experience of 'external' ownership (and possibly investment) – albeit with the 25% cap – will come with the recognition of LDPs (see paragraph 2.3 above).

An additional concern (which is also relevant to the 'transitional' issues raised in paragraph 3.4 below) is whether, and how, a 'level playing field' can be maintained when organisations with considerable financial resources position themselves for entry into the legal services market – even if initially only in relation to non-reserved activities. In the short term (certainly until the new regulatory changes that are needed by law firms to allow external investment), incumbent providers of legal services may find themselves at a competitive and financial disadvantage because they lack access to capital – as well as the regulatory flexibility to enter into 'anticipatory' arrangements.

#### 3.2 The nature of 'appropriate' ownership and 'fitness to own'

As stated in paragraph 2.6(7) above, the holding of restricted interests by non-lawyers must be approved by the licensing authority. The statutory expression of whether or not someone might be considered an appropriate owner is found in Sch 13, para 6:

- (1) the holding must not compromise the overarching regulatory objectives of the Act set out in s. 1(1);
- (2) the holding must not compromise the compliance by the ABS or by any employee or manager who is an authorised person in relation to a reserved legal activity of their duty in s. 176 to act in accordance with the requirements of their professional regulator;
- (3) the holder must be "otherwise a fit and proper person to hold that interest"; and
- (4) in making its assessment, the licensing authority must have regard to:
  - (a) the person's probity and financial position,
  - (b) whether the person is disqualified or included on the Legal Services Board's list of people in respect of whom a licensing authority has objected to, or imposed conditions on, their holding of a restricted interest,

- (c) the person's associates (cf. footnote 17 above), and
- (d) "any other matter which may be specified in licensing rules".

When considering whether non-lawyers could be regarded as appropriate owners of a law firm, the Clementi Report adopted a 'fitness to own' test (*Review of the Regulatory Framework for Legal Services in England and Wales*, Final Report 2004, Chapter F, para 40). This would have had regard to an applicant's:

- (i) honesty, integrity and reputation;
- (ii) competence and capability; and
- (iii) financial soundness.

Although the Department for Constitutional Affairs indicated that these same criteria would be part of the legislative fitness-to-own test<sup>18</sup>, only the factors in (a) and (c) would seem to have been explicitly included in Sch 13, para 6. Consequently, competence and capability would only be considered if licensing rules specifically so required – unless, presumably, there was evidence of an applicant's incompetence or lack of capability that was judged to compromise the regulatory objectives, compliance with professional standards or regulations, or otherwise be so gross as to make the applicant manifestly not a fit and proper person. In other words, in the absence of express provision in licensing rules, competence and capability become, negatively, matters relevant to withholding approval rather than, positively, conditions for granting approval.

The Institute believes that the fitness-to-own test will be a key component in the credibility and success of ABSs. In its response to the SRA Consultation Paper on character and suitability for non-lawyer managers in LDPs, the Institute submitted:

In our view, the fundamental weakness of the Consultation Paper is that it avoids addressing the issue of competence or capability when assessing the suitability of an applicant as a 'manager'. In his original proposals for LDPs, Sir David Clementi expressed the 'suitability' of non-lawyer managers in terms of a 'fitness to own' test (*Review of the Regulatory Framework for Legal Services in England and Wales*, Final Report 2004, Chapter F, paragraph 40). His explicit expectation was that such a test would include competence and capability. However, we would go further, and suggest that a fitness-to-own test should be applied more widely than non-lawyers.... The question ought not to be about the suitability of non-lawyers to be 'managers', but rather about the suitability of *anyone* to be a 'manager' of an LDP. The implicit assumption that solicitors (or even lawyers generally) are suitable to be managers, and that others must be assessed relative to them, strikes us as a tendentious starting point.

In our view, the new legislative framework provides an opportunity to define what 'managers' need to be able to do, and then to apply that definition, on an entity basis, to all recognised bodies and to all 'managers'. This would be preferable to persisting with the failure to distinguish between the competence and suitability of those who should be authorised to deliver legal services and the competence and suitability of those who should be approved to own and manage the entities through which those services are delivered.

When introducing the character and suitability test for LDPs, the SRA moved somewhat from its original position in the Consultation Paper, but the approach taken is nevertheless that predicted above, namely, that competence and capability become, negatively, matters

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<sup>18</sup> See *The Future of Legal Services: Putting Consumers First* (2005), para 6.6.

relevant to withholding recognition rather than, positively, conditions for granting it. The relevant provision is in the Recognised Bodies Regulations 2009<sup>19</sup> relating to initial recognition (Regulation 2.3(d)) which allows the SRA, when deciding to refuse an application, to take into account that it “is not satisfied that the managers of the applicant body, taken together, have sufficient skills and knowledge to run and manage a business which provides regulated legal services”. There is therefore no test of competence or capability for individual managers but the Regulations do, at least, meet the Institute’s concern that the overall assessment of management capability is applied to all managers whether lawyers or not. The question for debate now is whether the same approach should be adopted in relation to ABSs.

### 3.3 The Degree of Ownership

As discussed in paragraph 2.6(7) above, the Legal Services Act adopts 10% as its material level of ownership requiring approval (albeit with power for licensing authorities to specify a lower level); and a higher percentage than these levels may be specified for controlled interests. Sir David Clementi was quite clear that, as a matter of principle, lawyers should be in the majority by number of managers (*Review of the Regulatory Framework for Legal Services in England and Wales*, Final Report 2004, Chapter F, paras 61, 69 and 101). His rationale was that the majority should be “committed through qualification to the ethical standards to be expected of a law practice” (para 69).

The Government did not incorporate this limitation into the Act, preferring a more permissive framework. Nevertheless, the Government had envisaged in the White Paper that degree of ownership would remain a policy issue for consideration by the Legal Services Board (see paragraph 2.2 above). It would, therefore, still remain open to the Board or licensing authorities to adopt a policy of refusing licences when a restricted interest exceeds 49.9% or alternatively, in a mirror image of the approach to a ‘low-risk body’ (see paragraph 8 below), impose more stringent regulations or conditions on licences where lawyers are not in a majority of management or control of the ABS. There could usefully be a debate about whether, why and in what circumstances such a policy should be considered.

### 3.4 Investment

While there might be doubt in some quarters about the need or appetite (of law firms and investors) for non-lawyer investment – and the effect of the ‘credit crunch’ and its consequences for the availability of capital – there does seem to be a level of interest in the marketplace. One of the factors not often appreciated by lawyers is that private equity and other investors welcome the opportunity to enter regulated markets precisely because they are regulated: regulation creates barriers to entry, and therefore provides a degree of protection or insulation for their investment. For this to be attractive, though, the regulation has to be proportionate and effective.

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<sup>19</sup> See footnote 3 above; at the time of writing, these Regulations are still in draft form and subject to final approval.

The SRA is, in practice, likely to be the first – and principal – licensing authority for ABSs. It indicated in November 2007<sup>20</sup> that, until the new ABS regulations are in place, the current regulations apply. Although these have recently allowed solicitors' firms to access a wider range of investment, the rules still require those firms to remain independent. The purpose of any fee-sharing arrangement under which investment is introduced or rewarded must be "solely to facilitate the introduction of capital and/or the provision of services" to the firm (Solicitors' Code of Conduct 2007, Rule 8.02(1)(a)). Although a non-lawyer fee-sharer may properly require the firm to observe service delivery standards in return for the capital or services, nothing in the arrangement must influence or constrain a solicitor's professional judgement in giving advice to a client (Rule 8.02(1)(b)). Nor must the arrangement amount to a partnership or breach of the referral fee rule (Rule 8.02(1) (c) and (e)). These provisions appear to have been little used in practice, and there is some difficulty in determining a fair allocation of fees as between the firm and a non-lawyer fee-sharer.

The SRA also expressed the view in the same paper that "contractual arrangements which include provision for the future sale of an ownership interest in a firm, in return for investment or services now, could breach the fee sharing rule and compromise independence" (para 4.8). Firms entering into arrangements in advance of the ABS regulations must therefore be careful.

The inevitable uncertainty arising from lack of knowledge of the final structure and requirements of ABS regulations gives rise to some 'transitional' issues relating to acceptable sources, types or providers of funding in the run-up to ABSs, including:

- (a) the extent to which those entities that wish to lend to or fund potential ABSs can impose controls on the participating law firms without contravening current regulations in respect of independence, ownership and control;
- (b) the extent to which current regulations on fee-sharing in return for interest or capital can be used to reward an entity providing funds, investment or services;
- (c) the basis on which a licensing authority might challenge commercial arrangements relating to fee sharing in return for services or capital (or both);
- (d) the nature, extent and acceptability of interim arrangements under which external ownership will eventually be achieved by the grant of an ABS licence; and
- (e) the degree of separation required under interim arrangements between the solicitors' practice and the administration, processes or other services of an entity wishing to introduce capital and/or share profits.

A discussion paper originating in the United States has also raised the intriguing possibility of whether law firms could create derivative financial instruments<sup>21</sup>, and it could be worthwhile to explore the prospect and implications of such instruments in the context of the Legal Services Act and ABSs.

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<sup>20</sup> See *Legal Services Act: New forms of practice and regulation* (2007).

<sup>21</sup> Center for the Study of the Legal Profession (2007) *Law firms, ethics, and equity capital: a conversation* (Washington DC, Georgetown University).

### 3.5 New Degrees of Separation

The implications of external ownership and investment carry with them a need for greater clarity and recognition of the separation of functions or stakeholder interests. They include:

- (1) Ownership and production: a feature of the 'traditional' professional partnership has been the owner-worker role of partners. The separation of the roles of owners and producers brings the possibility that non-lawyers will occupy both roles (though the position and responsibilities of the lawyer-HoLP are intended to ensure compliance with the Act, the terms of the ABS's licence, and the professional principles) – and even that lawyers might not be owners at all (though again subject to the duties of the HoLP and the HoFA). The scope for ownership and management influence from backgrounds of different professional requirements and expectations (or indeed not qualified professionally at all) therefore increases, and with it the pressures on professional duties and principles, undue influence, and other issues that Clementi identified in his review (these pressures are addressed in paragraphs 2.5 and 5.2 below).
- (2) Ownership and control: in part, this arises from the 'traditional' corporate distinction between ownership and management (which again has so often been confused in professional partnerships where the owner-manager role is combined). Relationships between shareholders and directors will be likely to follow a different pattern in ABSs to those experienced in partnerships. The potential conflict between the duty to shareholders and a lawyer's duty to clients and to the court will need to be addressed. In Australia, although never tested legally, the prospectus and constitution of Slater & Gordon Ltd (the world's first publicly floated law firm) expressly state that the lawyers' duties to clients and to the court take precedence over the duty to shareholders<sup>22</sup>. The role of the HoLP and HoFA will be vital in maintaining the required balance of commercial success with independence and integrity.
- (3) Ownership and finance: also likely to change is the historical combination of internal equity (eg partners' contributed or retained capital) and external debt (eg bank overdraft and asset financing). The possibility of internal equity from non-lawyers within the firm as well as truly external equity from those outside the firm (cf. paragraph 3.1 above) brings the prospect of more imaginative use of holding and financing structures, as well as of employee benefit trusts. Regulation must anticipate and address the policy and operational implications of these changes. In particular, the effect of exit strategies on the stability, continuity, and funding of ABSs, as well as any perceived need to change the timing or practice of regulator intervention in struggling or suspect firms, will need careful consideration.

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<sup>22</sup> This conflict of duties is explicitly identified as a key risk in the Prospectus. The hierarchy of duties is set out as primarily to the court, secondarily to clients, and then to shareholders (*Slater & Gordon Limited Prospectus* (2007), paragraphs 1.3, 7.12 and 8.2). Indeed, it is further stated that the firm's lawyers might be required to act "against the interests of Shareholders and the short-term profitability of the Company" (paragraph 7.12). The Legal Services Commissioner for New South Wales played an active role in shaping and agreeing the expression of these professional responsibilities and the hierarchy of duties.

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## 4. Service Combination

### 4.1 Strategy

The introduction of new types of owners or sources of capital is likely to bring with it a different approach to the strategy of legal services businesses and to the combination of professional and other services within the same commercial entity or brand. There is some risk here that we are moving into a new world of legal services that we do not yet fully understand, and this inevitably makes it more difficult to regulate appropriately and effectively. We must avoid shifting from one form of monopoly which is generally agreed to be no longer acceptable towards another one which is more commercially or strategically driven – but equally unacceptable if it captures work and defines the way in which the service is delivered such that consumers' freedom of choice is restricted or destroyed. The regulatory challenge will lie in balancing strategic and commercial objectives with the regulatory objectives in s. 1(1) of the Act. Indeed, there is an argument that such new combinations are necessary or desirable for improving access to justice, protecting and promoting the interests of consumers, and in promoting competition in the provision of legal services (s. 1(1)(c), (d) and (e)). Possible issues that regulations and the policies or responses of licensing authorities will have to address include:

- (a) the appropriateness of certain service combinations (eg legal and financial services); there is a difference between, on the one hand, extending and facilitating consumer choice and, on the other, having combinations of services forced on the market with the intention of shaping consumers' expectations of what they should want to choose;
- (b) the need for or desirability of excluding certain services from combination with others – perhaps particularly in the context of MDPs (eg legal services and audit); and
- (c) the effect of some service combinations or substitutions on access to justice or legal services more generally (eg the substitution of virtual access for physical access, or the effects of firms 'cherry-picking' the services they offer and refusing to offer others<sup>23</sup>); this was an issue that Clementi believed was independent of the debate about the source (lawyer or non-lawyer) of capital and, if there was a concern about access, "it would be a matter for the Government to address openly" in consultation with providers and regulators (*Review of the Regulatory Framework for Legal Services in England and Wales*, Final Report 2004, Chapter F, para 52).

### 4.2 Separate Businesses Rule

Many practitioners feel that the separate businesses rule (Rule 21 of the Solicitors' Code of Conduct 2007), which requires a law firm effectively to keep all of its legal services as one business rather than being able to 'hive off' certain services to separate businesses, places them at a competitive disadvantage. For example, although will-writing is a non-reserved activity and can be provided by non-lawyers without any regulation or client protection,

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<sup>23</sup> Cf. paragraph 2.1 above.

solicitors are not allowed to run a will-writing business as a separate activity (Rule 21.02(1)(f)). They must therefore bear the costs of regulation that apply to them as solicitors – costs that are not borne by their unregulated competitors (cf. the discussion in paragraph 2.6(2) above about this regulatory gap). As new competitors with a focus on non-reserved activities and the ability to invest large amounts of capital position themselves strategically and competitively in the run-up to ABSs, incumbent law firms could find themselves at a significant timing disadvantage in establishing their own competitive positions and brands in a changing marketplace.

For competition to flourish, and for solicitors not to suffer an unwarranted disadvantage, regulation of ABSs must consider the continuing justification for the required business integration of all 'solicitor-like' services. There needs to be an exploration of the rationale for and against separation, and of alternative ways of securing the protection of the underlying or necessary characteristics of 'solicitor' and of the client and public interest in circumstances where separate structures or brands appear strategically, commercially or operationally sensible or necessary.

### **4.3 Abuse of Dominant Position**

Much of the regulation of lawyers has, historically, proceeded on the basis that clients and the public need protecting from dishonest, unprofessional or charlatan practitioners. In many situations, this protection still needs to be maintained. However, in recent years, increasing concerns have arisen about the bargaining power of 'volume providers' of legal work to law firms, and their ability to dictate terms of business, staff to be engaged on work, methods of delivery to be adopted, and so on.

The influence of these large institutional suppliers of legal work (such as insurance companies and banks) and monopsony buyers (such as the Legal Services Commission) is such that the exercise of their power in general, and any desire they might have for acquiring, requiring or encouraging non-lawyer ownership or investment interests through an ABS, must be considered carefully and fully in the regulatory framework of the future. If clients are to reap the benefits of competition and improved service delivery, then the potential for deliberate or inadvertent misleading of them about service, reputation, or results, and the transparency of any introduction or referral arrangements (as well as panel selection and internet auction processes), must be addressed robustly. Some would argue that recent experience of third-party capture of, say, personal injury work holds warnings of market distortion and (at best) ambiguous freedom in the selection of legal representation.

More generally, the ability of large providers of legal services (whatever their origin) to influence or even distort the market by, for example, increasing their market share, linking legal services and other products and services (cf. paragraphs 4.1 above and 4.4 below), or using predatory pricing to drive other (smaller) providers out of the market, should be taken into account as part of the operation of the licensing framework.

If ABS licensing rules follow the template of the LDP regulations, then consideration should be given to whether the SRA's powers to impose (in the public interest) conditions to a

licence would be adequate for this purpose. The SRA's powers in relation to LDPs allow it to (Recognised Bodies Regulations 2009, Regulation 4.2<sup>24</sup>):

- (a) limit, restrict, halt or prevent an activity which is putting or is likely to put at risk the interests of clients, third parties or the public; or
- (b) limit, halt or prevent a risk to clients, third parties or the public arising from a business agreement or association which the ABS has or is likely to enter into, or a business practice which the ABS has or is likely to adopt.

For ABSs, there is also an express obligation (in s. 83(5)(b)) on a licensing authority to state in its licensing rules how it proposes to take account of the regulatory objective of improving access to justice (which objective could, of course, be compromised by the abuse of a dominant position). There may also be general issues of competition law and policy and experience to be drawn on.

#### **4.4 Higher-risk Objectives**

The licensing of businesses that might take a much wider (or narrower) view of delivering legal services, or of combining those services with other goods and services (or both), or of pursuing economic objectives, could give rise to sensitive or contentious policy issues relating to the approval of ABS activities. It is conceivable that some ABS licences or applications for licences will appear to carry higher risk in their strategic objectives than the legal services market has traditionally been used to. For example, to what extent (if at all) should a licensing authority consider the size and acceptability of (say) an applicant's current or intended market share, its overt pursuit of short-term income, or its diversification into related or non-related services? A potential justification for such regulatory interest could relate to the heightened possibility of the ABS's collapse from the pursuit of higher-risk objectives, perhaps compromising access to justice or leaving vulnerable or disadvantaged client groups without adequate access to local legal services.

Where a licensing authority does consider such issues, then thought must be given to whether the requirement on it to consider<sup>25</sup> the Act's regulatory objectives and compliance with the professional principles, combined with its ability to impose conditions, would provide sufficient safeguard against the perceived risks.

### **5. Service Delivery**

#### **5.1 Competence and Quality**

It cannot be tritely asserted that ABSs and the involvement of non-lawyers as owners, managers, or investors will inevitably lead to the 'dumbing down' and a decline in quality of legal services. First, the brand reputation of potential new entrants suggests that they

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<sup>24</sup> See footnote 3 above; at the time of writing, these Regulations are still in draft form and subject to final approval. Regulation 4.2 allows conditions to be imposed for more purposes than those outlined here, but these two purposes seem most relevant to the potential 'dominant abuse' activities of an ABS.

<sup>25</sup> The effect of ss. 28(2), 82(1), 83(5)(b), 85(6) and (7), and Sch. 11, para 17.

may have a lot at stake and will be reluctant to risk their entire reputation on the provision of sub-standard legal services. Second, it is not the case that lawyers universally and uniformly deliver high quality services, as the number of complaints and the outcome of disciplinary hearings attests. Third, the Legal Services Act requires that:

- (a) reserved legal activities should be delivered only by those who are appropriately qualified (Sch 11, para 16);
- (b) an ABS must have “suitable arrangements” in place (Sch 11, para 17) to ensure that lawyers comply with the rules of their professional regulator (s. 176) and that non-lawyers do not do anything which might cause a breach of those rules (s. 90); and
- (c) the Head of Legal Practice should take “all reasonable steps” to ensure the compliance of lawyers with their duty under s. 176 and of non-lawyers of their duty under s.90, and to report any failures to the licensing authority (s. 91(3) and (4)).

The combination of these commercial imperatives, statutory requirements and the ABS licensing rules, together with an ethical mindset and ‘education for compliance’ (cf. footnote 13 above), will do much to assure quality. There are also specific issues, considered in the following subparagraphs, where work must be done to enhance and preserve the quality of legal services.

## 5.2 Conflicts of Interest

The Department for Constitutional Affairs suggested that it would be for the Legal Services Board to provide clear rules about preventing conflicts of interest in respect of services provided by ABSs (*The Future of Legal Services: Putting Consumers First* (2005), para 6.9). However, in his final report, Sir David Clementi had taken a stronger line on the issue of conflicts in LDPs (*Review of the Regulatory Framework for Legal Services in England and Wales*, Final Report 2004, Chapter F, paras 53 and 54):

53. A further concern relates to possible conflicts of interest. A lawyer in an LDP must be in a position to assure his client that he approaches any instructions with an independent mind and no conflict of interest. He must approach any fresh instructions with ‘clean hands’. The lawyer may well feel that he is able to do this, but where the owner has an interest in the issue there will be a suspicion (where the lawyer follows his professional duty it would be an unwarranted suspicion) that the lawyer may be influenced by this. It is, therefore, proposed that an LDP may not take instructions on a case where the owner has an adverse interest in the matter. Thus, if a bank were to own an LDP, that LDP could not act for a client on any matter in which the bank had an interest, for example advising a client on loan documentation to which the bank was a party<sup>26</sup>. In this context, by ‘interest’ is meant a direct

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<sup>26</sup> The DCA referred to exactly the same example in *The Future of Legal Services: Putting Consumers First* (2005), para 6.9. However, it did not suggest that there is a clear conflict of interest and that an ABS should not act. Rather, the example is used in connection with the “potential leverage that owners may have on an ABS firm [and which] will depend on the size of their stake in it”. In the context of this example, “there is likely to be a higher risk in allowing the firm to act for a client where the bank has an interest”. The Department’s view therefore seems to be relative rather than absolute.

interest in the legal outcome of the matter being dealt with, rather than the economic one of an owner wishing to provide a satisfactory, rewarding service.

54. It should not be permissible for the owner, under the terms of the LDP's regulatory conditions, to interfere in any client case or to have access to any individual client files or client information.

Taken literally, this latter point about access to client information might be thought to undermine some of the strategic or commercial rationale of cross-selling that would encourage new entrants to establish ABSs in the first place – and, if it did, could subvert the Government's intention to promote competition, innovation and one-stop-shops. The Legal Services Board and licensing authorities might accordingly be pressed to express an early policy view on whether (and if so, why and to what extent) they intend to adopt the Clementi approach to this issue.

The Legal Services Act would seem to place its faith in:

- (a) the professional principles (particularly that lawyers should act "with independence and integrity" and "in the best interests of clients": s. 1(3)(a) and (c));
- (b) the obligation on licensing authorities to have suitable arrangements in place to ensure that the ABS and any of its managers and employees who are authorised persons maintain those principles (Sch 11, para 17(2)(b)); and
- (c) the duty of the HoLP to take all reasonable steps to ensure that the ABS complies with the terms of its licence and report any failure to the licensing authority (s. 91(1)).

The Act therefore adopts a less prescriptive approach than the Clementi Report advocated; but it would nevertheless be possible for the Legal Services Board and licensing authorities to adopt Clementi's recommendations. It might accordingly be helpful to know whether the Board and licensing authorities intend to spell out as policy or as licence terms (or both) their view of conflicts of interest<sup>27</sup> and adverse interests, and particularly whether their view would be different depending on the nature of the conflict or adverse interest or on the nature or extent of a non-lawyer's ownership or influence in the ABS.

### 5.3 Resources

The provision and maintenance of quality services depends crucially on the quality of, and the nature of a firm's access to, the resources it needs. Increasingly, new approaches to access (for example, through joint ventures, franchises, service companies, white-labelling, out-sourcing, and off-shoring) add to the challenges of management and supervision. The advent of ABSs is perhaps likely to continue and extend this trend, as well as introduce other possibilities. Regulation will need to consider whether express provision is needed in relation to the use of specific resources, or of forms or structures of access to them. Specifically, thought will need to be given whether the approach taken by the SRA in

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<sup>27</sup> In December 2008, the SRA announced a consultation process on relaxing the requirements of the Solicitors' Code of Conduct 2007, Rules 3 and 4, relating respectively to conflicts of interest, and duties of confidentiality and disclosure (available at: [www.sra.org.uk/securedownload/file/1650](http://www.sra.org.uk/securedownload/file/1650)).

relation to LDPs and the imposition of conditions on licences (cf. paragraph 4.3 above) will represent a sufficient regulatory armoury for this purpose.

## 5.4 Intermediaries

The interposition of intermediaries and referral agencies between law firms and their clients has become a more pervasive feature of the supply chain of legal services. There is already a debate about the nature and acceptability of such relationships, referral fees and other rewards, and about the transparency and disclosure that is required in the public and client interest. Again, the establishment of ABSs might potentially exacerbate some of these issues, and the Legal Services Board and licensing authorities will need to be mindful of the implications, for instance, for competition and access to justice, a client's selection of a lawyer of choice, the scope for creating one-stop-shops, the potential for conflicts of interest and (the reality or perception of) undue interference with a lawyer's independence. In this sense, a discussion of whether or not referral fees are a help or hindrance in achieving the Act's regulatory objectives would be worthwhile.

## 6. Management

### 6.1 Role of Lawyers

This paper has already alluded to the change in role that lawyers face in relation to their 'director' status, and the likely increase in the use of professional managers (see paragraph 3.5 and the paper referred to in footnote 1 above). It has also explored Clementi's view that lawyers should form a majority of ownership and management (see paragraph 3.3). Within the context of the Act, the role of HoLP assumes a significant and pivotal importance in ensuring professional integrity in the delivery of legal services through ABSs. Consequently, the specific approach of licensing authorities and the content of licensing rules relating to the qualification, approval, and discharge of duties by a HoLP will be of crucial importance.

The nature of a licensing authority's conditions or procedure for determining whether someone is a 'fit and proper person' to be designated as a HoLP (Sch 11, para 11(4)) will be particularly interesting. The Institute's view is that the requirement that a HoLP must take all reasonable steps to carry out the duties in s. 91<sup>28</sup> does not mean that a lawyer who is an authorised person in relation to one of the reserved activities for which the ABS has its licence (cf. Sch 11, para 11(3)(b)) is automatically or necessarily to be regarded as a fit and proper person to be designated as a HoLP.

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<sup>28</sup> That is, that the ABS complies with the terms of its licence, that lawyers act in accordance with the requirements of their professional regulator, that non-lawyers do not contribute to a breach by lawyers of their professional obligations, and that any failures of compliance by the ABS, its lawyers or non-lawyers are reported to the licensing authority.

## 6.2 Management Competence

One of the driving forces leading to the Clementi review was the number and nature of complaints against lawyers and law firms. Many of these complaints concern 'management'.

The Institute argued in its response to the SRA on the issue of character and suitability of non-lawyer managers in LDPs (see also paragraph 3.2 above) that the new legislative and regulatory framework provides an opportunity for regulators to address, define and supervise the competence and quality of management in the delivery of legal services:

The new statutory framework of the Legal Services Act 2007 should encourage law firms and regulators to improve the ownership and management of those entities that deliver legal services. Entity regulation provides an opportunity to decide what competence and skills should be required of those in ownership and management positions. Rather than extending a 'professions' approach to ownership that assumes that those who are legally qualified are suitable and competent to own and run a business, the issue of who is suitable to be a 'manager' should be addressed from a different starting point. The days of the more-or-less 'gifted amateur' and 'reluctant managing partner' approach to law firm management need to be laid to rest. Defining the competences required is an important and necessary development in securing the confidence of clients and the public that the entities providing legal services are managed effectively and efficiently. It is also, in our view, a necessary part of the process of reducing the number of complaints against providers<sup>29</sup>.

Law firms in the future will need the skills and competences of properly trained and experienced managers who are able to combine that background with the principles of professionalism and compliance with the regulatory framework.

We would again urge that this opportunity is taken in relation to ABSs. We recognise that such an approach presents challenges. Nevertheless, others have attempted to meet these challenges (as, for instance, in Australia) and we believe that other avenues of insight and support (such as the Chartered Management Institute) could be explored. Our intention would be that, in the public interest and with an eye to consumer protection, some degree of qualification, certification or accreditation should be explored (see further paragraph 7 below).

## 7. Education

The introduction of ABSs into the legal services market will change the business landscape for regulators, clients, the public, lawyers, non-lawyers, new entrants, investors, lenders, other advisers, and suppliers. Consideration should therefore be given to the educational implications in respect of:

- (1) Clients and the public: the Legal Services Act includes a regulatory objective of "increasing public understanding of the citizen's legal rights and duties" (s. 1(1)(g)). While this is covered by the current approach to Public Legal

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<sup>29</sup> Cf. footnote 13 above.

Education<sup>30</sup>, the Legal Services Board will have to address the issues as part of its remit. It will also need to consider whether this should also extend to education for clients and the broader public about the sorts of businesses or organisations from which legal services will be available in the future<sup>31</sup>, how to make enquiries about resolving or resourcing their legal needs, the terms of engagement that should or might be expected with the providers of legal services, and the resolution of complaints.

- (2) Lawyers: thought should be given to the need for any changes to the educational requirements for qualification, and for continuing professional development. Depending on the view taken by the Legal Services Board and licensing authorities, there might be a case for specific training for those lawyers who become owners or managers in ABSs or seek designation as a HoLP (cf. paragraph 6.1 above).
- (3) Non-lawyer managers, investors and new entrants: again, depending on the view taken by the Legal Services Board and licensing authorities, there might need to be specific training for those non-lawyers who:
  - (a) are involved in the delivery or support of legal services (including their duty under s. 90 not to cause or substantially contribute to a breach of professional obligations by lawyers);
  - (b) become owners or managers in ABSs (including an understanding of the nature of reserved legal activities, the duties of lawyers, and the obligations placed on them by the Act, the licensing rules and any conditions on their licence);
  - (c) seek designation as a HoFA (their qualifications and duties).

In our response to the SRA's consultation on character and suitability for non-lawyer managers in LDPs, we said:

The SRA is also given the power in section 9(2)(fa) of the Act as amended<sup>32</sup>, to make provision about the education and training requirements to be met by the managers of recognised bodies (a power that is not restricted to those who are not legally qualified). No doubt Parliament inserted the power in the expectation that it should be used, and it would in our view be a missed opportunity not to introduce a training and competence element as part of the character and suitability process for (in our view, all and not just non-lawyer) managers.

Although (surprisingly and disappointingly) there is no express equivalent to s. 9(2)(fa) in relation to ABSs, there is a general power for licensing authorities to include "further provision" relating to "the managers of licensed bodies" and "the arrangements for the management by them of the licensed body and its activities" (Sch 11, para 10). Further, in

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<sup>30</sup> The Public Legal Education Network has a current site at [www.plenet.org.uk](http://www.plenet.org.uk); there is also a Public Legal Education and Support (PLEAS) task force archive site at [www.pleas.org.uk](http://www.pleas.org.uk). The Ministry of Justice also convenes a PLE Strategy Group, chaired by Lord Bach.

<sup>31</sup> This could extend to sources and funding of advice, including law centres and other advice agencies, services provided *pro bono*, on-line enquiry and provision, legal aid, and so on.

<sup>32</sup> The Act referred to here is the Administration of Justice Act 1985 (new provision inserted by the Legal Services Act 2007, Sch 16, para 81(4)(e)).

relation to the approval of the holders of restricted interests (cf. paragraph 2.6(7) above), licensing rules *must* make provision about the procedures that will be applied by the licensing authority in deciding whether the person is a fit and proper person to hold the interest (Sch 13, para 6(4)), and in making its assessment, the authority must have regard to “any other matter which may be specified in licensing rules” (Sch 13, para 6(3)(d)). The Act therefore offers scope for the Legal Services Board and licensing authorities explicitly (if they so choose) to determine that they will require evidence of appropriate qualification, certification or accreditation for either or both of ownership and management.

Specifically in relation to the HoLP and HoFA (who occupy key management and compliance roles in ABSs), licensing rules *must* make provision about “the procedures and criteria that will be applied by the licensing authority when determining ... whether an individual is a fit and proper person” to carry out the duties of the post (Sch 11, paras 12(1)(a) and 14(1)(a)). Again, these provisions would be broad enough to support specific rules relating to the appropriate evidence of competence, education and training of the HoLP and HoFA.

In all cases, of course, there remains the key question of the precise nature (and provider) of any education or training required or qualification, certification or accreditation required or accepted as evidence of competence or suitability for appointment.

## 8. Special and 'Low-risk' Bodies

Consistent with risk-based and proportionate regulation, the Legal Services Act envisages that some ‘special bodies’ should not be subject to the full rigour of the ABS licensing regime (s. 106). These include independent trade unions, not-for-profit and community interest bodies, and low-risk bodies. A low-risk body is one in which fewer than 10% of the managers are non-lawyers or other ABSs, and fewer than 10% of the shares or voting rights in the body or its parent are held by non-lawyers or other ABSs (s. 108). While some of the general ABS licensing rules must still apply (s. 106(7) and (8)), some others (including the requirement for a HoLP and HoFA) need not (s. 106(3)). In reaching a decision about the licensing rules to be applied in any given case, the licensing authority must take into account the reserved and non-reserved legal activities carried on, the nature of the body’s clientele, and any non-lawyers who hold an interest in the body or who are managers of it (s. 106(5)).

As with the issue of the authority to regulate the non-reserved activities of non-authorized persons (cf. paragraph 2.6(2) above), the absence of a service or product approach to regulation could potentially leave consumers facing different approaches to regulation and redress depending on whether they have sought advice from ‘fully’ regulated law firms or ABSs, differently regulated special or low-risk ABSs, or unregulated providers of non-reserved activities.

Businesses considering taking limited advantage of ABS opportunities, and who would satisfy the 10% criterion, would probably welcome early indication from the Legal Services Board and licensing authorities of their likely approach to low-risk bodies and the nature of any modifications to the licensing rules that they are minded to consider.

## 9. Risk, Complaints and Insurance

Changes in the business entities through which legal services are provided and clients access those services will undoubtedly bring additional risks – resulting from either or both of their structure or operations. Dissatisfaction with new entities and different approaches to delivery might well spark more complaints and claims. The Institute hopes that there will be an early and extensive dialogue among regulators, the Legal Complaints Service (and the new Office for Legal Complaints) and indemnity insurers about the perceived risks of these new arrangements. In particular, an investigation of the value of ‘appropriate management systems’ in reducing complaints (and possibly insurance premiums) should be greatly encouraged<sup>33</sup>.

If risk-based and proportionate regulation is to be a reality, then ongoing methods for data collection and analysis of market conditions and responses would be at least desirable, so that regulators can continue to assess the effects of regulatory intervention or exhortation. Ways should be explored for the results and implications of such research to be passed to and considered by the Legal Services Board, the Office for Legal Complaints, regulators and licensing authorities.

## 10. Orderly Exits

It is quite likely that some existing firms will be in the future be destabilised by new developments in the marketplace and by competition from new and different routes to market. It is also likely that new entrants and investors will fail in their ventures. Consideration needs to be given early on to the appropriate framework of support, intervention and regulation to achieve the orderly exit of these businesses from the market. Earlier intervention in failing or suspect firms, better approaches to the notion of ‘successor practices’, and alternative ways of covering run-off liabilities might be worthy of exploration.

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<sup>33</sup> Cf. footnote 13 above.

## Materials

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## The Legal Services Policy Institute

The Legal Services Policy Institute (LSPI) was established by the College of Law in November 2006. Its principal objectives are to:

- (a) seek a more efficient and competitive marketplace for legal services, which properly balances the interests of clients, providers, and the public;
- (b) contribute to the process of policy formation, and to influence the important policy issues, in the legal services sector and, in doing so, to serve the market and public interest rather than any particular party or sectional interest;
- (c) alert government, regulators, professional bodies, practitioners and other providers, and the wider public, to the implications of these issues; and
- (d) encourage and enable better-informed planning in legal services by law firms and other providers, government, regulators and representative bodies.

The Institute seeks to form and convey independent views; where the College might have views as a provider of education, these are expressed separately.

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