

**Understanding barriers to entry, exit and changes to the structure of
regulated legal firms**

Final Report

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TABLE OF CONTENTS

1. Introduction: issues and objectives	5
2. Relationships between barriers to entry, exit and mobility (changes in business structure and strategy).....	8
2.1. The meaning of the term ‘barriers’	8
2.2. The notion of <i>economic</i> cost and its implications	9
3. Market and Regulatory Context	11
3.1. Introduction.....	11
3.2. Recent market evolution and adaptation.....	11
3.3. Entry and exit	15
3.4. Changes in ownership structure	18
3.5. Regulatory framework	20
3.5.1. Legal Services Act 2007.....	20
3.5.2. Regulated providers of legal services.....	22
3.5.3. Outcomes-focused regulation	23
3.5.4. Risk based assessments	24
3.5.5. The public interest rationale for regulations	26
3.5.6. SRA Handbook	27
4. Authorisation and Outcomes based regulation.....	29
4.1. Introduction.....	29
4.2. SRA authorisation requirements	29
4.2.1. Applying for authorisation.....	29
4.2.2. SRA assessment of authorisation applications.....	31
4.2.3. Rationale, benefits and costs of authorisation requirements.....	32
4.3. Assessment of the authorisation process.....	33
4.3.1. A proportionate approach to authorisation?.....	33
4.3.2. Authorisation of alternative business structures	34
4.3.3. Authorisation of sole practitioners	35
4.3.4. Maintaining authorisation.....	36
4.3.5. Interim conclusion on authorisation.....	37
4.4. Outcomes-based regulation.....	39
4.4.1. Assessment of particular outcomes	39
4.4.2. Other relevant sections of the SRA Handbook	42

5. Entry	48
5.1. Introduction: specific issues arising at the entry stage.....	48
5.2. General assessment of the purpose and effectiveness of entry rules: the implications of risk-based and outcomes-focused regulation.....	49
5.2.1. Entry into and progression through the profession.....	53
5.3. Other studies on potential barriers to entry	54
5.4. Interim conclusion on entry	55
6. Mobility	57
6.1. Introduction.....	57
6.2. SRA Handbook and business structure changes	59
6.3. Notification and approval requirements in mergers	62
6.4. Assessment of effectiveness of mobility rules	63
6.4.1. Trends in mobility	63
6.4.2. Suitable buyers.....	63
6.4.3. Impact of insurance.....	65
6.4.4. Mobility and solicitors' culture.....	66
6.5. Interim conclusion on mobility	67
7. Exit	69
7.1. Introduction.....	69
7.2. Rules and procedures affecting exit.....	69
7.2.1. Regulations relating to firm closure	69
7.2.2. Client management requirements.....	70
7.2.3. Informing the SRA and other parties	71
7.2.4. Indemnity insurance requirements	71
7.2.4.1. A firm shutting-down with indemnity insurance policy.....	71
7.2.4.2. A firm shutting-down with no indemnity insurance policy	72
7.2.4.3. Succession and indemnity insurance.....	72
7.2.5. Wider client protection arrangements	72
7.2.5.1. Solicitors Indemnity Fund	72
7.2.5.2. Compensation Fund	73
7.3. Other factors affecting exit	73
7.4. Assessment of effectiveness of exit rules	75
7.4.1. Indemnity insurance requirements	75
7.4.2. Client management and notification requirements.....	76
7.4.3. Run-off insurance requirements.....	77
7.4.4. Risk of inefficient exit decisions.....	78
7.4.4.1. Disorderly exit	79
7.4.4.2. Continued operation at a minimal level to avoid exit costs ('zombie firms').....	80
7.4.5. Future trends in exit	81
7.4.6. Interim conclusion on exit	83

8. Overall Assessment	85
8.1. The project specification and the project findings.....	85
8.2. Entity regulation and the <i>ex ante</i> supervision of financial arrangements, business models and governance.....	88
8.3. The problem of poor policy targeting.....	91
8.4. The problem of excessive duplication	92
9. Alternatives	95
9.1. Introduction and framework for assessing alternatives	95
9.2. Views on alternatives.....	96
9.2.1. The overall position.....	96
9.2.2. Possible responses to general issue 1: insurance.....	96
9.2.3. Possible responses to general issue 2: ‘too much’ (<i>ex ante</i>) regulation of business structures, business models, finances and governance.	98
9.2.4. Possible responses to general issue 3: Poorly targeted regulation	99
9.2.5. Possible responses to general issue 4: Duplication	100
10. Final comments.....	103
References	105
Glossary	108
List of Annexes	109
Annex 1: Research sand methodology	109
Annex 2: List of characteristics of interviewees	109
Annex 3: Small scale surveys	109
Annex 4: Detailed survey questionnaires	109
Annex 5: Suggestions of interviewees for changes in regulations.....	109
Annex 6: Alternative business strategies among interviewees	109

1. INTRODUCTION: ISSUES AND OBJECTIVES

The Regulatory Policy Institute was commissioned by the Legal Services Board (LSB), supported by the Law Society, to undertake a study of possible barriers to (a) entry, (b) exit, and (c) changes in the business structures of regulated solicitors' firms/practices in England and Wales; and the findings of this study are set out in what follows. The focus of the work is, as was requested, on small solicitors' practices, with particular attention given to the consideration of barriers to change that might either be caused or exacerbated by current regulatory arrangements, or that might be amenable to reduction via modification of those arrangements.

As set out in the research specification (see Annex 1), LSB and Law Society interest in the relevant issues was stimulated by the recognition that entry, exit and firm restructuring are important aspects of the capacity of suppliers of goods and services in any market to respond and adapt to changing circumstances. The capacity to respond and adapt relatively quickly – often referred to as flexibility – is important for the effective performance of a market, particularly in periods of substantial change.

The broad aim of the study was “to explore the regulatory and other barriers in the legal market(s) to solicitor practices closing, merging or otherwise changing their legal structure” and, building on this, “to consider ways in which regulators or others could support improved market flexibility”.

More specifically, the study sought to:

- Identify barriers to market flexibility linked to entry, exit, merger or other changes in business structure (e.g. mergers between solicitor and conveyancer firm), ownership or finance;
- Identify the specified or implicit aims of barriers and their cost/benefits;
- Assess the extent to which the barriers protect consumers or meet other intended aims.

In exploring the relevant issues we first considered the effects of regulation on barriers to entry, exit and changes in structure by separately examining the implications of each of a range of individual, potentially relevant factors, including, but not limited to, the exemplary list set out in the specification:

- Required run-off insurance cover;
- Duties to clients in the event of close down;
- Retention of records after a firm is closed;
- Requirements on firms to ensure the suitability of buyer;
- The market for individuals or firms looking to purchase solicitor firms;
- Legal requirements on dissolving partnerships;
- Tax liabilities on firms seeking to close or dissolve partnerships;
- Run-off requirements where firms are transitioning to a new business form e.g. solicitor firm to conveyancer firm.

Since obstacles to entry, exit and structural change are potentially influenced by a wide range of factors, barriers may exist on account of accumulations of small effects arising from a range of influences, as well as because of a material effect attributable to a single factor. Further, since

regulations are generally open to at least some degree of interpretation, their effects are often heavily influenced by the ways in which they are framed and enforced. Our exploration of barriers to market flexibility therefore necessarily involved consideration of these additional matters (cumulative effects, framing and enforcement of regulations).

The next step in our approach was to assess the relationships between regulatory barriers to market flexibility and regulatory objectives. Barriers are not necessarily harmful in and of themselves, and they may, in relevant contexts, serve regulatory objectives. Indeed it is trite economics that, depending on circumstances, effective market functioning can frequently *require* commitments that limit subsequent flexibility (long-term contracts being a much cited example).

In making this assessment we have carefully considered the content and structure of the relevant regulatory objectives, before addressing questions such whether regulations and their enforcement are:

- not focused on a clear objective and therefore likely unnecessary;
- focused on a clear objective, but the circumstances are such that the objective could be achieved in a more proportionate, alternative way;
- focused on a clear objective, well designed, but through poor delivery/enforcement are proving disproportionate;
- focused on a clear objective, proportionate and well delivered.

Finally, in responding to the research specification, the study seeks to identify and consider alternative ways forward in those cases where existing regulatory approaches appear to be problematic. It is beyond the scope of the study to conduct full regulatory impact assessments of these alternatives, which would require both more comprehensive identification of *ranges* of alternatives, and evaluations of the possible effects of each option relative to the others and to the *status quo*. Thus, whilst the alternatives discussed are ones that we believe are both feasible and capable of contributing to the better achievement of regulatory objectives, the assessments should in all cases be interpreted as preliminary to a fuller regulatory assessment.

The study was based chiefly on a combination of desk research – which assessed the legislative background, the Solicitors Regulation Authority (SRA) Handbook and other text-based material (including explanatory documents, commentaries, articles, market statistics, and the like) – and 34 interviews with a range of people who are knowledgeable about the market for the services of regulated solicitors’ practices. (Annex 2 provides a list of characteristics of the interviewees.) It also rested to a lesser extent on the authors’ extensive knowledge of regulatory issues in other sectors, other jurisdictions and other historical periods (some of which are obviously more relevant to legal services than others) and on small scale surveys of practices (see Annex 3 for details), which were designed to provide supplementary information that could serve as cross checks on emerging themes in the desk research and interviews, and which gave us 101 responses to consider. We are grateful to all those who assisted us in these exercises either by being willing to be interviewed or by responding to a survey questionnaire.

Our general approach followed that adopted in an earlier Regulatory Policy Institute study on the burden of regulation, commissioned by the Cabinet Office.¹ In particular we considered whether different pieces of evidence drawn from the different limbs of the study ‘stacked up’ with one another. Where they did, we considered that the evidential basis for the relevant inference was relatively firm, with the ‘firmness’ depending on the degree of coherence in the various indicators. Neither the interviews nor the surveys were intended to be, and should not be interpreted as, self-standing exercises from which inferences can be drawn without reference to the other sources.

More specifically in relation to the interviews, the citations in the Report are used to give expression (often in the words of the interviewee) to a view that is supported by wider evidence across the sources, not to suggest that this was a typical view among those we talked to.² Indeed, one of the most obvious facts that can be reported is that within the more than forty-thousand word record of interviews is to be found a wide variety of views on regulatory matters, perhaps reflecting the increasing specialisation and fragmentation of the market that has been noted by a number of commentators and analysts. For the most part, the citations reflect a point made by a number of interviewees, but in one or two cases they are a singular view (though, as stated, always a view that finds support from other sources). Since the interviews were not rigidly structured – they were based around sets of points of departure for discussion – interviewees were free to make points that they themselves considered important, and we were struck by how frequently that opportunity was taken. We have therefore tried, in reporting on views, to give a flavour of some of those freely offered points.

Given this background, the central sections of this report are concerned respectively with assessments of entity authorisation, entry conditions, exit conditions, and changes in the structures of established firms/practices. They are preceded by two ‘scene-setting’ sections. The first addresses some conceptual and analytical issues that merit discussion so as to clear the ground for what comes later. The second examines a few high-level statistical indicators of the extent to which the relevant market has been responding to recent economic ‘shocks’, most notably the general recession in the economy starting in 2008 and its most immediate consequences (e.g. a sharp fall in the demand for conveyancing services), but also including policy-driven changes such as those emanating from the Legal Services Act 2007 (the LSA) and from the more recent legislative changes concerning legal aid and personal injury work.

The central part of the Report is in turn followed by sections containing our overall assessment of the impact of regulatory arrangements on market flexibility and a discussion of possible implications of the findings based around consideration of alternative, potential developments in regulation.

¹ *Pilot Study of a Combined Postal, Telephone and Structured Interview Methodology for Assessing the Impact on Business of Existing Regulation, Final Report*, November 2004, http://www.rpieurope.org/Publications/Final_RPI_Report_on_impact_of_regulation.pdf

² In any event, the number of interviews – although around twice that originally planned at the outset of the study – and the diversity of contexts in which different interviewees operated would have impeded any attempt to identify a ‘typical view’, even if such existed.

2. RELATIONSHIPS BETWEEN BARRIERS TO ENTRY, EXIT AND MOBILITY (CHANGES IN BUSINESS STRUCTURE AND STRATEGY)

2.1. The meaning of the term ‘barriers’

The concept of barriers to entry is one of the most fundamental in the economic analysis of competition in markets, but it can be, and has been, defined in different ways by different scholars. These differences arise chiefly from some of the subtleties that are to be found at the intersection of economics and competition law, where the issues of interest are to do with questions concerning abuse of dominance or anti-competitive agreements among firms.

The issues addressed in the current study are somewhat different, however. Although competition is an important consideration, the specific issues are not to do with the potential economic effects of anti-competitive behaviour by firms, but rather are to do with the potential economic effects of the ‘rules of the game’ on market performance.³ The immediate questions posed concern the implications of current ‘rules of the game’ for the flexibility and adaptability of solicitors’ firms in responding to changing market circumstances.

On this basis, we can proceed by taking a relatively straightforward view of what constitutes a ‘barrier’ to entry, to exit or to a change in a practice’s business structure/strategy (henceforth referred to as a barrier to mobility⁴): a ‘barrier’ is simply an *economic* cost that is incurred or triggered by the relevant event, whether entry into the market, exit from the market, or a change in firm structure and strategy. The reference to an *economic* cost is of significance here, for reasons that will be explained in the next sub-section.

Since most change leads to incurred costs, barriers to entry, exit and mobility are ubiquitous in the economy. The matters of interest, therefore, are to do with the materiality of the height of such barriers in the market for solicitors’ services, and, more specifically, with the question of whether they are unnecessarily high on account of the existence of certain parts of the ‘rules of the game’ which could be amended or reformed without significant loss in terms of the achievement of other (than market flexibility/adaptability) economic, social or political benefits.

Critically, the entanglement of entry, exit and mobility barriers implies that a given change in the ‘rules of the game’ (i.e. a given change in regulations) is liable to give rise to *simultaneous* changes in these different barriers/costs. It is therefore not generally possible to analyse particular aspects of the regulations as if they only affected one set of barriers/costs, even in circumstances where the regulation has been introduced to address problems that are perceived to exist in only one of the three areas (entry, exit and mobility). For obvious reasons, this significantly increases the complexity of the evaluative tasks.

³ As explained in previous Regulatory Policy Institute work on the regulation of legal services, the term ‘rules of the game’ is a shorthand expression for all those institutional features that are liable to affect the conduct of market participants. These include formal law, regulations, social norms, common understandings, and so on. See C. Decker and G. Yarrow, *Understanding the Economic Rationale for Legal Services Regulation*, Legal Services Board, 2010.

⁴ Reflecting the fact of change or ‘movement’ in business structures and/or strategies.

2.2. The notion of *economic cost* and its implications

An economic cost is incurred when, in order to do something, something else of value is given up. The cost is the value of that which is given up.

To illustrate, if £1 million is invested in a business, the economic cost of that investment is the return that could have been made, usually measured over a period of one year, in the next best investment with similar risk characteristics. This is different from, and much smaller than, the initial cash outlay (of £1 million); and also different from what an accountant might record as the cost of capital of the business. Thus, if the £1 million came from personal savings and takes the form of an equity investment, the accounts may attribute no cost at all to the investment. Alternatively, if the £1 million is borrowed at fixed interest, a capital cost in the form of interest payments made/due in the year will be recorded in the accounts.

Whilst they may appear esoteric, these distinctions are fundamental to understanding the entangled natures of barriers to entry, exit and mobility in a market. Consider, for example, the position of a new entrant who, after a short period, realises that he/she has not made the best of decisions and decides to exit the relevant market. If the value of expenditures (including expenditures of time and effort, as well as cash outlays) made in order to enter the market are *recoverable* on exit, then these expenditures are not barriers to entry. It is only to the extent that such expenditures are *irrecoverable* (usually referred to in economic terminology as *sunk*) that they are properly counted as barriers.

To make the point more concrete, it can be noted that one of the points made to us in the course of one of the interviews conducted for this study was that the acquisition of a small established legal practice could, for some would-be entrants, be the lowest-cost route for new entry into the market. If correct, it is to be expected that sellers of such practices – i.e. those wishing to leave the market – will be able to achieve a higher selling price than would otherwise have been the case (in the absence of the possibility of such acquisitions). In these circumstances, those exiting should be able to recover at least some of the expenditures they themselves faced on entering the market, implying the existence of lower barriers to both exit and entry (because of cost recoverability) than would otherwise have existed. Moreover the market for acquisitions of legal practices will be more active the lower the barriers to mobility, since acquisition will frequently be accompanied by significant changes to firm structure, strategy and governance on the part of the acquirer. In this way, promoting lower barriers to mobility will also tend to promote lower barriers to entry and to exit.

Another illustration of the linkages among the various barriers is to be found in insurance arrangements. One matter of particular contention has been the regulatory requirement to take out run-off insurance, which, under current arrangements, triggers a payment when a practice is closed down. *Prima facie* this appears to be a simple barrier to exit, but the actual position is rather more complex.

Solicitors' professional indemnity insurance is written on a claims-made rather than an occurrence basis, which is to say that the insurance covers the claims against the insured falling within the policy period, irrespective of the year of occurrence of the events that give basis for the claim. One potentially indirect effect of this set of arrangements is that, if insurance markets are competitive,

the approach serves to reduce the initial costs of insurance for new entrants, relative to alternative ‘occurrence-based’ insurance arrangements, *other things being equal*. In the first insurance year, for example, a claims-made insurer will take on liabilities triggered by a combination of first-year occurrences and first-year claims, but will not take on liabilities associated with first-year occurrences that lead to claims in later years. It can be expected, therefore, that the former will be offered at a lower price than the latter.

3. MARKET AND REGULATORY CONTEXT

3.1. Introduction

Before delving into the detail of entry, exit and mobility issues, we consider that two aspects of the relevant context merit initial discussion. They are:

- broad indicators of the degree of flexibility/adaptability of the market in recent years, and
- the structure of current regulation as it applies to solicitors and solicitors' practices in England and Wales.

In each case, we will make a number of preliminary observations that will be taken up again in later sections of the report.

3.2. Recent market evolution and adaptation

The most obvious first point to note about the market for services provided by regulated solicitors' firms is that, over the past decade or so, this has been a growth market, whether measured in terms of turnover or employment. The growth in the number of practice certificate holders (PCHs) was not halted by the 2008 downturn, notwithstanding the severity of the effects of the credit crunch on other sectors of the economy and also on areas of legal practice such as conveyancing. Figure 1 shows that there was a distinct slowing down in growth in 2008 but that the strong upward trend was then restored in the next three years up to 2011. Only in 2012 was there a (small) fall in the number of PCHs.

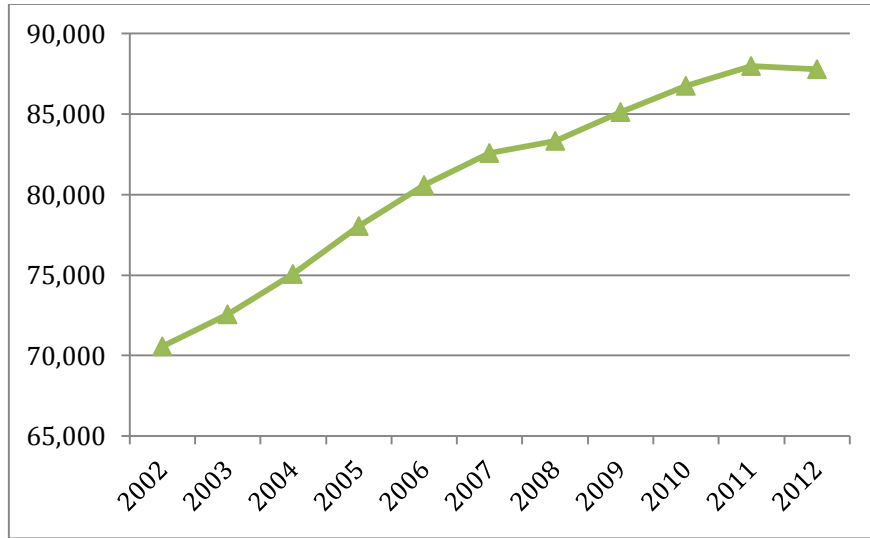
Whilst the observed growth could obviously have been achieved with a constant or declining number of firms, the number of practices also increased over the period (see Figure 2). The data show a dip in the number of private practice firms in 2005, but that appears to be the result of changes in the way firms are classified (i.e. what is counted as private practice) rather than anything that actually happened in the market. Discounting the dip in 2005, there is a clear upward trend in the number of firms until 2010, followed by a subsequent fall-back, implying that more new practices have been created than have been lost due to closures and amalgamations, and hence that there has been significant new entry over the last ten years.

The percentage increase in practice numbers is lower than the percentage increase in practising certificate holders, which in turn implies that the average practice size has been increasing.

Figure 3 confirms the expectation, with the only pause occurring at the onset of the credit crunch in 2008.⁵ Given the overall upward trend, the reductions in private practice firms in 2011 and 2012 are particularly notable, and are of relevance when examining the entry and exit record (see section 3.3below).

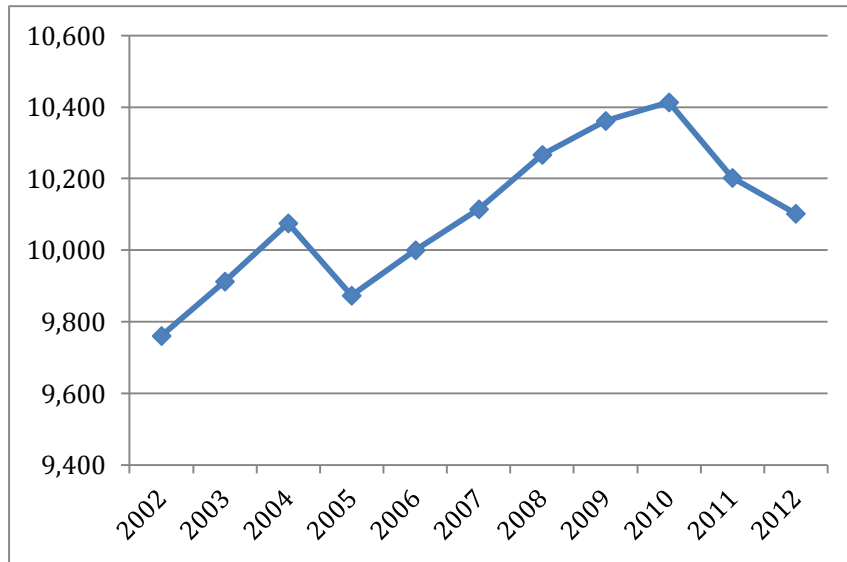
⁵ The abnormally sharp upward movement in PCH's per firm in 2005 can be attributed to the fall in recorded in PPFs in that year, and is likely also a statistical artefact.

Figure 1: Practice certificate holders (PCHs) working in private practice firms (PPFs) in England and Wales



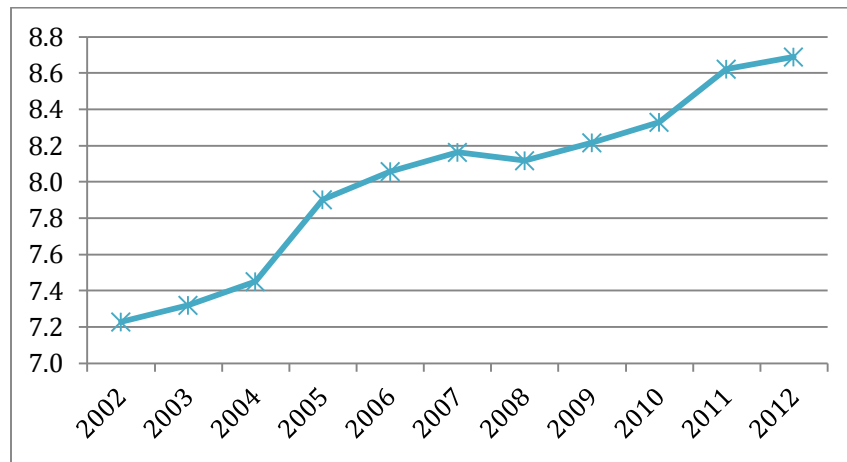
Source: Law Society

Figure 2: Private practice firms registered in England and Wales



Source: Law Society

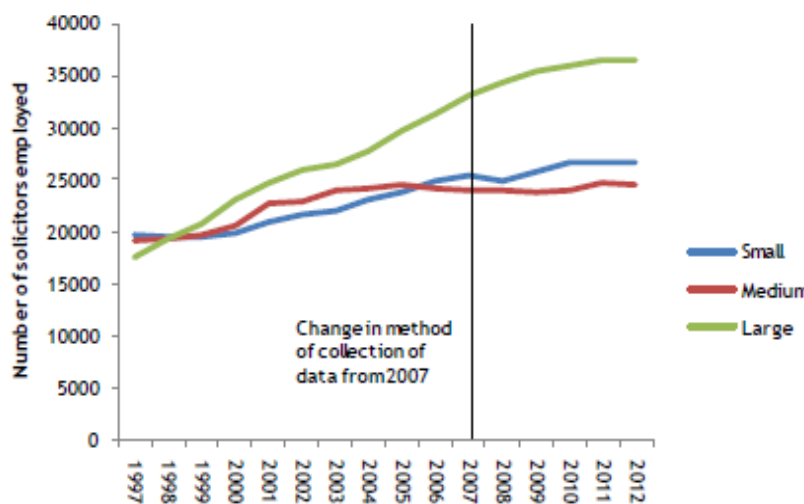
Figure 3: Practice certificate holders per private practice firms in England and Wales



Source: Law Society

The evidence indicates that the underlying upward trend in the number of solicitors has been a characteristic of the small practices' segment of the market, as well as of the market as a whole. Employment growth has been highest among the largest firms, and weakest for medium-sized firms, as indicated in Figure 4, based on Law Society categorisations of 'large', 'medium' and 'small' firms.

Figure 4: Number of solicitors employed by size of firm (1997-2012)



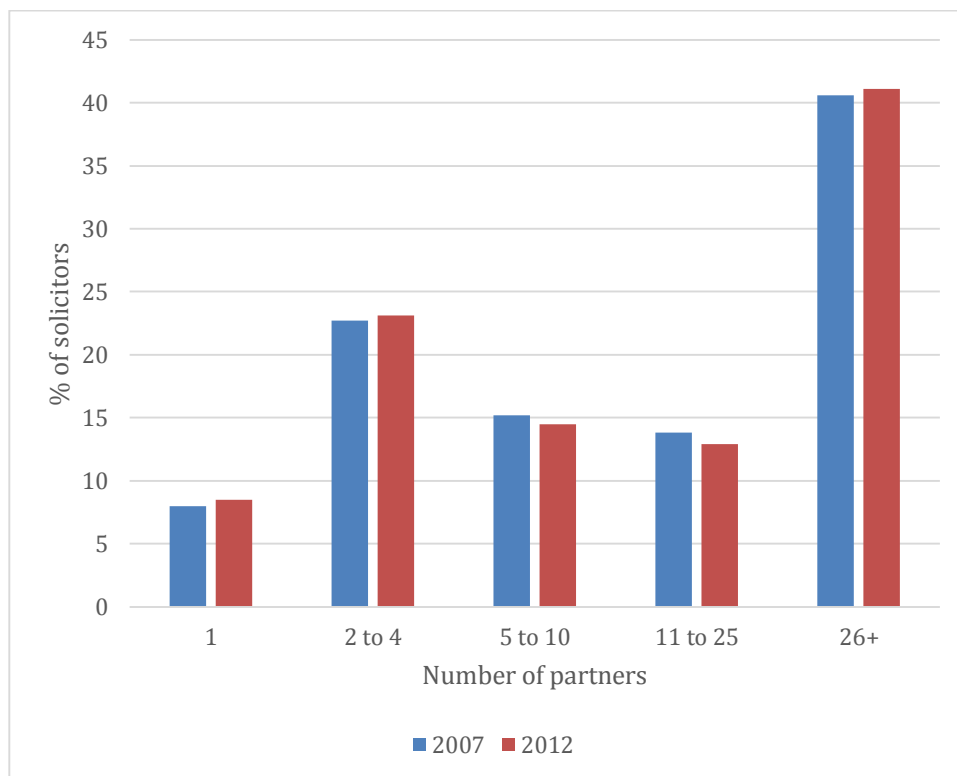
Source: Law Society, Annual Statistical Reviews, 1997-2012.

The differences in growth rates among different sizes of practice are indicative of significant structural adjustment in the market over a fifteen year period. In 1997 the number of solicitors in large firms was the lowest among the three categories, but by 2012 it was much the highest. Small-firm numbers have grown steadily throughout the period, at a slower rate than for large firms, whereas the medium category (now the smallest of the three) has been static since about 2003.

Moreover, within the small firm grouping, the smallest practices have, in aggregate, been more than holding their own.

Figure 5 shows the number of practising solicitors accounted for by each of a number of size bands of firms, and it indicates that both sole practitioners and two-to-four partner practices increased their shares over the period 2007-12, albeit relatively slightly.

Figure 5: Distribution of solicitors among firms of different sizes



Source: Law Society Annual Statistical Reviews, 2007 and 2012.

Taking the numbers together, impacts of the credit crunch appear to have been relatively subdued and somewhat delayed compared with many parts of the economy. UK employment peaked in the spring of 2008 and, whilst there was a slowing in the growth of practice certificate holders in that year, growth accelerated again in 2009 and continued at a relatively robust rate in a period when

general employment was contracting. By the time that the number of practising certificate holders started to fall, total UK employment was increasing again.

The initial picture, then, is one of definite adjustment and change on the supply side of the market, but at an *initial* pace that, from the perspective of many other sectors of the economy, might be judged to have been on the slow side⁶ – a picture that we subsequently sought to explore more fully in the course of the interviews with practitioners and others with knowledge of the market.

3.3. Entry and exit

Solicitors Regulation Authority (SRA) data on openings (entries) and closings (which is one form of exit, the other being sale of a practice) for the 26 months to July 2013 are shown in Figure 6. These indicate an entry rate of around 9.8% per annum, which is to say that, for every 10 established practices at the beginning of a year, one new practice opens by the end of the year. This is a high entry rate compared with some other sectors, but a percentage point or two lower than the entry rate for enterprises across the economy as a whole.⁷ On a standard, three-way economic classification (high, medium, low) the data indicate that, on a *prima facie* basis, the barriers to entry are not ‘high’ at an aggregate level, averaged across sub-segments of the market, and are most probably ‘low’. We will consider later, in section 5, the question of whether there are nevertheless significant entry barriers for particular sub-groups of would-be suppliers.

To provide a feel for what this type of rate implies at the level of the market as a whole, it can be noted that if (a) such a rate persisted over a five year period, (b) the exit rate (closures plus amalgamations) was also 10%, and (c) the exit rate was the same for firms of different ages⁸, then, after five years, around 40% of the practices that would then be operating would have been formed within those five years.

This moderately favourable view of entry barriers is supported by the pattern of openings of new practices over time. There is a downward trend in openings that continues until the end of 2012. Although the subsequent data period is short, there then appears to be significant pick-up in the rate of new entry. Such a turnaround is consistent with the existence of adverse business prospects in the market through to the end of 2012, but of improved prospects since then.⁹ It therefore correlates with short-term macro-economic developments, and indicates supply-side responsiveness to those developments.

⁶ This does not imply that very recent adaptations by practices have been slow. Indeed it is often a feature of a lack of flexibility in adaptation to changing circumstances that when adjustments do come, they can be more dramatic and sometimes less orderly than would have been the case if flexibility had been higher at the outset.

⁷ See Office for National Statistics (ONS), *Business Demography 2012*.

⁸ This is a strong assumption. In most sectors, failure rates of new firms are significantly higher than those of established enterprises. On the other hand, there are a large number of established solicitors’ practices that are sole proprietorships, and, amongst these, older established practices might tend to have high closure rates, connected with the retirement of the proprietor. Responses from the surveys suggest that the former effect dominates among firms of solicitors (see below), although the sample size is small and this can certainly not be assumed to be a definitive result.

⁹ This is again a summary of an overall or average position, and it does not mean that all parts of the market fit the overall/average pattern.

The observed, high rate of new entry into the market leads naturally to two questions:

- What happens to new entrants in years immediately following entry? Do most of them survive and prosper in the longer term, or is there a relatively high attrition rate?
- Within what appears to be a favourable general picture, are there types of entry – entry on the basis of alternative business structures being the most obvious example, although not necessarily the only one – that are inhibited by disproportionately high entry barriers?

The first of these questions is a matter that is relevant when assessing the risks faced by new entrants, and hence should be of some interest to the SRA (we will come back to this point later, when considering the significance of the SRA’s competition objective). The limited evidence available to us comes to us from a small survey of recently closed practices (see Annex 3), and suggests that new entrants do have higher closure rates than established firms (see Table 1 below¹⁰). Taken on its own, this information is insufficient to reach any very firm conclusion, but the implied three- and five-year survival rates are very similar to those for UK business enterprises across all sectors in recent years.¹¹ Moreover, the pattern of survival rates is readily explicable in terms of some underlying economics. Particularly when the future is more than usually uncertain, new entry can be regarded as experimental: new firms are set up with a view to entering the market and (a) expanding within it if things go to expectations and plans, but (b) exiting from the market if things do not go so well.

Table 1: Survey of recently closed practices

How long had your firm been established (before it was closed)?		
	answered question	21
	skipped question	2
	Response Percent	Response Count
Less than three years	38%	8
Three to five years	14%	3
Six to ten years	5%	1
Eleven to twenty years	24%	5
More than twenty years	19%	4

¹⁰ The percentages in Table 1 are not closure rates, and need to be interpreted in the light of the general significance of practices of different ages within the total population of practices. Within the survey sample of firms that are currently operating, firms less than three years old comprised 13% of the population and firms more than 20 years old comprised 54%. Putting the two sets of figures together implies a closure rate that is about 8 times higher for young firms than for old firms. We would not suggest attaching any great weight to this number (because the surveys were not designed to provide reliable estimates of this kind of indicator (age-related closure rates) – and hence the relegation of this discussion to a footnote – but we do think it is reasonable to infer that closure rates have probably been significantly higher for young firms than for old firms over recent years.

¹¹ ONS, *Op. Cit.*

These points signify a major question for the conduct of risk-based regulation in legal services. If the regulatory aim is to reduce risk as defined by the SRA, might this not lead to disproportionate enforcement effort being allocated to the assessment of new entrants and, more generally, to any other changes that might be considered to involve more than average experimentation and innovation (such as new business plans or structures consequent on amalgamations), and hence to involve higher than average levels of risk being undertaken? Considerable attention will be devoted to this question in the main sections below.

The issue raised is also closely associated to the second of the above questions. Within any cohort of new entrants, or of any set of amalgamations, some of the business plans and/or financial arrangements and/or management structures will be more experimental/innovative/unusual than others. Might it also be the case, therefore, that as well as being disproportionately attracted to change in general, enforcement resources under risk-based regulation might be disproportionately attracted to those changes that are the most experimental/innovative/unusual?

The underlying policy question is, of course, whether risk-based regulation, in the particular context of interest, has the effect of chilling flexibility, adaptation and innovation.

Turning to some preliminary statistics on the level and pattern of firm closures, Figure 6 below suggests that both may be more problematic than the overall statistics for openings. The unusual peaks in September are obviously linked to the common insurance renewal date for solicitors' practices, which has now been abolished. The annual closure rate over the twenty four month period shown is around 4.2%, which is much lower than the opening/entry rate. Moreover, to the extent that there has been a trend in the numbers over the period, it is downward. The closure figures are, therefore, less correlated with general economic conditions than are the entry/opening statistics: an economically 'similar' (to entry) pattern in closures would have been an increasing rate of closure up to the end of 2012, followed by a fall in the rate of closure since then.¹²

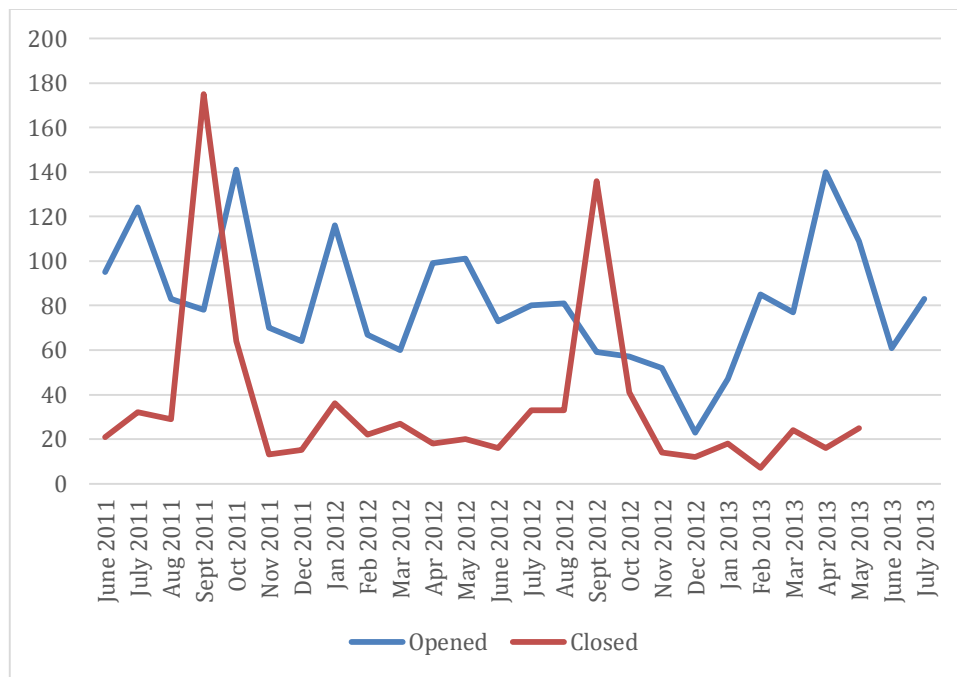
The fact that entry rates are substantially higher than closure rates in a period when the overall number of practices was falling suggests a significant rate of merger or amalgamation among established practices. This is consistent with the results of surveys by Jomati Consultants of the largest law firms¹³: twenty one of the leading one hundred firms were found to have been involved in an amalgamation/merger in 2011, and the number rose to twenty six in 2012. It is also confirmed more generally across the population of solicitors' practices – albeit at a lower average rate – by information provided to us by the Law Society on entry and exit, which included details of reasons for exit.¹⁴

¹² We note, however, that these points are more than usually provisional because the closure record is so heavily influenced by the September observation each year. Although the common renewal date has now been abolished, it was still in place in September/October 2012, and hence the great bulk of insurance contracts will still expire at the end of September 2013. A sharp peak in closures in September 2013 is therefore likely, and it may take a number of years for the spike to disappear.

¹³ Reported in the Financial Post, <http://business.financialpost.com/2013/01/10/u-k-stats-indicate-international-law-firm-mergers-increasingly-necessary/>

¹⁴ This information also confirmed that business restructuring was much the most important factor accounting for the gap between the SRA's openings and closing statistics, adjusted for the net change in the

Figure 6: Openings and closings of practices



Source: Solicitors Regulation Authority

There are differences between the SRA and Law Society data on openings and closings which it is beyond the scope of this study to address. However, from the numbers available, it is possible to make a simple, approximate estimate of the rate of exits associated with business restructuring over the 2011 and 2012 period. Figure 2 suggests a net annual exit rate averaging around 1.5% over 2011 and 2012. Since the net exit rate per annum (-1.5%) = the rate of openings (9.8%) less the rate of closures (4.2%) less the rate of loss due to amalgamations and other factors, an upper bound amalgamation rate can be estimated as 7.1% per annum. Given that the Law Society information on reasons for exit indicates that ‘other factors’ play a small role relative to business restructuring, we estimate the rate of exit associated with business restructuring to have been a little less than 7% per annum. That is, one in every fourteen or fifteen practices per annum appears to have exited via amalgamation over this recent period.

3.4. Changes in ownership structure

Further evidence of structural change in the market is to be found in the changing structure of ownership arrangements. Alternative Business Structures (ABSs) have received the most attention in many of the discussions of such arrangements, but their numbers (and turnover) remain small at the current time relative to other forms of ownership.

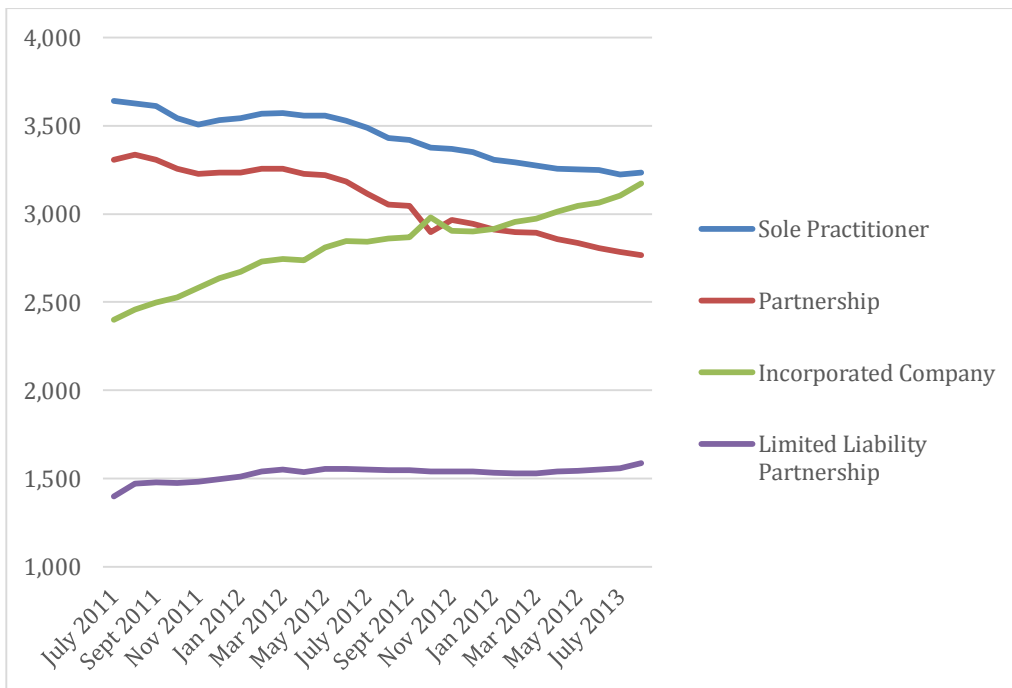
total number of practices. A much smaller factor was the disappearance from the statistics of practices that no longer required recognised body status.

Figure 7 gives practice numbers for the main ownership types -- sole proprietors, partnerships, limited companies and LLPs – in the 25 month period ending in July 2013. The numbers of sole proprietors and traditional partnerships have fallen; the number of incorporated companies has risen very sharply, and the number of LLPs has risen modestly, largely in two bursts, one at the beginning and one at the end of the period.

The percentage changes over a period of 25 months were as follows:

Sole proprietors	-11.2%
Partnerships	-16.4%
Incorporated companies	+32.2%
LLPs	+13.5 %

Figure 7: Numbers of practices by type of ownership



Source: Solicitors Regulation Authority

Over such a short period, these can only be described as substantial changes in the ownership structure of the supply side of the market, indicating that, under the surface of a slow-moving total number of practices over the relevant period (see Figure 1), significant movements have been taking place. Thus, for example, if the current rate of decline in the number of partnerships was maintained for a five year period, one third of all existing partnerships would disappear via one route or another (closure, amalgamation, change in legal form) by the end of the period.

More speculatively, to the extent that the incorporated company is a more flexible form of ownership – for example, because it makes amalgamation and take-overs easier to effect – it might be argued that the rise of this type of ownership will help establish greater flexibility and adaptability on the supply side of the market in future periods.¹⁵

3.5. Regulatory framework

3.5.1. Legal Services Act 2007

The Legal Services Act 2007 provides the foundation for the current regulatory arrangements for solicitors. The Act sets out eight objectives for the SRA that are shared with other regulators in the legal services sector. They are to:

- protect and promote the public interest;
- support the constitutional principles of the rule of law;
- improve access to justice;
- protect and promote the interests of consumers;
- promote competition in the provision of legal services;
- encourage an independent, strong, diverse and effective legal profession;
- increase public understanding of the citizen’s legal rights and duties;
- promote and maintain adherence (by authorised persons) to professional principles.

Under the Legal Services Act 2007, section 28, the SRA and other approved regulators must, so far as is reasonably practicable, act in a way:

- which is compatible with the regulatory objectives, and
- which the approved regulator considers most appropriate for the purpose of meeting those objectives.

¹⁵ This does not, of course, imply that such flexibility is the main rationale for the changes in ownership, only that it may be one of the effects of changes motivated by other factors. One interviewee who had moved from the status of an employed solicitor to that of a sole practitioner commented to us that the adoption of a limited company structure was motivated chiefly by a desire to safeguard against personal liability in the event of failure, not to make his firm more attractive for acquisition at a subsequent date, although he could also see the benefits for future acquirors.

The approved regulator must have regard to

- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and
- any other principle appearing to it to represent the best regulatory practice.

As the Legal Services Board (LSB) has noted: “*The regulatory objectives are not set out in any hierarchy in the Act. Indeed, any attempt to weight or rank them would be doomed to failure by the significant overlap and interplay between them.*”¹⁶ This poses an obvious challenge to regulators, since it opens up the possibility of fluctuating interpretations of objectives and the weighting to be accorded to them, giving rise to regulatory uncertainty. In principle, such uncertainty could serve to raise entry barriers, although the initial indicators discussed above do not suggest that this has been a major problem to date.

Repeating the words of the LSA, the SRA has said that it aims to “*ensure that regulatory interventions are transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed*” and “*ensure that best regulatory practice is adopted*”.¹⁷ These are familiar terms from the much wider ‘better regulation agenda’, and they raise no issues that are specific to legal services or are more important for legal services regulation than they are more generally. The general lesson from wider experience is that it is much easier to specify such aims than it is to show how they have affected any actual regulatory decisions.

On the basis of the documentary evidence, in many areas the main driving objectives for the SRA appear to be the broad categories of “protect the public interest” and “protect the consumer interest”. For example, in the foreword to the July 2013 Risk Outlook, the SRA Chief Executive emphasises that the SRA is “*focused upon protecting the public interest and clients of legal services*”.¹⁸ Similarly, in the Strategic Plan for 2013-2015 the SRA emphasises that it “*regulates in the public interest and is determined to ensure that the public are able to access safe, ethical, good quality legal services that meet their needs*”.¹⁹

Whilst the protection and promotion of consumer interests is a common feature of regulation in many areas of economic life, the protection of the public interest is a much vaguer notion that potentially opens the door to regulation of a type that has avoidable, adverse consequences for entry, exit and mobility barriers, a point that will be discussed further in section 3.5.5 below. Indeed, ironically perhaps, part of the advance made by the development of independent regulation in the UK has been seen in terms of the establishment of relatively specific, more precisely defined objectives, which are capable of being delegated, in place of the vague public interest objectives of earlier periods. (Herbert Morrison described the boards of public corporations as ‘high custodians of the public interest’.)

¹⁶ Legal Services Board, *The regulatory objectives, Legal Services Act 2007*, page 2.

¹⁷ Solicitors Regulation Authority (2012), *Strategic Plan 2013-2015*.

<http://www.sra.org.uk/sra/strategy.page>

¹⁸ Solicitors Regulation Authority (2013), *Risk Outlook 2013: The SRA's assessment of key risks to the regulatory objectives*, July, <http://www.sra.org.uk/solicitors/freedom-in-practice/ofr/risk/risk-outlook.page>

¹⁹ Solicitors Regulation Authority (2012), *Strategic Plan 2013-2015*, December, <http://www.sra.org.uk/sra/strategy.page>

3.5.2. Regulated providers of legal services

Any entity that provides one or more of the reserved legal services to the public must apply to the SRA for authorisation. Under the *SRA Practise Framework Rules 2011*²⁰ three different types of party can make an application for authorisation.

- Recognised bodies: These are firms with at least one solicitor or Registered European Lawyer (REL) manager, where all the managers and interest holders are lawyers and all professional services provided are ‘legal’ in nature. These are often referred to as ‘traditional’ business models. The firm can have a small amount (less than 10%) of indirect non-lawyer involvement.
- Licensable bodies (or Alternative Business Structures, ABSs): The Legal Services Act 2007 allowed for firms with Alternative Business Structures (ABSs) to be authorised. These are firms where at least one manager is a solicitor or REL or a lawyer authorised by an approved regulator or an individual with Bar Standards Board (BSB) registration. The firm can also have non-authorised persons (non-lawyers) as managers or interest holders. The firm can undertake a mix of legal and non-legal activities, offering multiple services to clients (i.e., be a multi-disciplinary practice). The firm can have external investment. According to the Risk Outlook 2013, the SRA had, at the time of that report, authorised more than 150 ABSs, varying in size and organisational structure.²¹
- Sole solicitors or sole practitioners.

The authorised entity can be one of a number of different business structures including sole practitioner, partnership, limited liability partnership (LLP) or a company. Sole practitioners have until very recently been authorised separately, but are now covered by the general Authorisation Rules. In each case the firm must meet all wider legal requirements (e.g. company law) relating to the relevant business structures.

Solicitors can in addition operate in an authorised non-SRA firm. This is a firm where all the work undertaken is of a type that can be authorised by another approved regulator. In addition, a solicitor can work in-house in a commercial business operating in another economic sector or market. In this case the solicitor works for his/her employer and not for other clients.

Until 2009, the SRA concentrated on regulating individual solicitors rather than the entities through which they practised. Subsequently all types of business model have become regulated as entities, including sole practitioners. Whilst the shift in focus is related to liberalisation that allows for business models other than the traditional law firm structure, the rationale for the entity focus is not entirely clear. It is unusual in other contexts to legislate for liberalisation – for example, by allowing new firms to compete with incumbent suppliers in telecoms, energy, water, air transport

²⁰ Solicitors Regulation Authority (2011), *SRA Practise Framework Rules 2011*, Rules dated 17 June 2011 commencing on 6 October 2011, <http://www.sra.org.uk/solicitors/handbook/practising/content.page>

²¹ Solicitors Regulation Authority (2013), *Risk Outlook 2013: The SRA's assessment of key risks to the regulatory objectives*, July, <http://www.sra.org.uk/solicitors/freedom-in-practice/ofr/risk/risk-outlook.page>

and rail – and then immediately regulate the business models, financial arrangements and governance structures of all firms in the market, including the new entrants.

This is an issue for us in that, unless it is very light-handed, entity regulation is a factor that can be expected to tend to affect barriers to entry, exit and mobility; and, if such a regulation lacks a convincing rationale, its impact on market flexibility will almost definitionally be disproportionate. While the SRA has said that its approach in authorising ABSs has not been to scrutinise the business models of the individual ABSs, our interviews suggested that, in practice and from the practitioners perspective, in at least some cases assessments have come very close being evaluations of an entity’s underlying business model.

To illustrate, in discussing entity supervision, the SRA website says that “*Engagement with firms may be triggered by events generated within or potentially impacting on a firm that mean that we need to check whether a firm's compliance might be at risk ...*”, and then goes on to state that:

“*An event includes such things as*

- *a report of misconduct against a firm and/or individual,*
- *significant change to a firm's composition or structure, and*
- *a downturn in a firm's financial indicators.”*

Thus, as the regulations are framed, merging firms can expect that they will create ‘an event’ that is liable to attract the attention of the SRA. This will raise barriers to mobility, save in circumstances where increased regulatory engagement imposes no material, additional costs or burdens on the firms involved in restructuring.

3.5.3. Outcomes-focused regulation

In claimed consistency with the objectives of the Legal Services Act 2007, the SRA has adopted an outcomes-focused, risk-based approach to regulation. It seems clear to us that outcomes-focused regulation was not specifically prescribed by the Legal Services Act 2007, and that it is the result of later, discretionary decisions in relation to implementation of the Act. The underlying rationale for the choices made by the SRA is not entirely clear, although the approach has been linked to changes in the statutory and market environments. Thus, the SRA notes in its policy statement *Delivering outcomes-focused regulation* that it is “*clear that a rules-based approach to regulation is inappropriate in such a changing environment*”²².

We do not find such clarity to be self-evident. The SRA’s own approach, including what is referred to as outcomes-focused regulation, is rules based in a certain sense²³. It is arguably the nature and properties of different sets of rules that matter, since some sets of rules work better than others.

²² Solicitors Regulation Authority (2010), *Delivering outcomes-focused regulation, Policy Statement*, dated 30 November 2010.

²³ The adopted regulatory language is not particularly helpful here. In ordinary language an outcome is the *consequence* of a prior action, implying a linkage between a particular act and its particular consequences. In the SRA’s new approach the outcome is detached from any one specific act and is intended to be used to evaluate a range of potential actions; but this requires that the outcome itself be capable of precise definition in order for it to be an operational criterion for assessing behaviour. The point is that precision/prescription is required somewhere in the ‘rules of the game’.

Recognition of this latter point leads to a ‘comparative institutions’ approach to regulatory assessment, of a type described in *Understanding the Rationale for Legal Services Regulation*.²⁴

The implementation of the new approach is in its early stages and our analysis of the arrangements should be considered in this context. In our discussions, SRA staff emphasised that this was a significant shift in the regulatory approach which was required under the Legal Services Act. It was also emphasised that the approach adopted reflects the complexity of the sector, and in particular the fact that, in SRA’s view, it was not possible to design a rule-book that could cover all types of firms. For reasons similar to those just given above, our own view is that the validity of this last statement is contingent on the nature of the rules under contemplation, and the rule of law is again a reference point: it is not self-evident that a single ‘rule-book’ is necessarily deficient in a society comprising diverse cultural groups, for example.

According to the SRA, in the *Regulatory Risk Framework*²⁵ the aim of the regulatory framework is to deliver outcomes for the public and for consumers consistent with the *objectives of the SRA*, in a way that encourages the regulated firms to consider how best to achieve these outcomes. This change in approach is intended to encourage innovation, including through the development of new business structures. Intentions can, however, differ from outcomes, and it is one of the purposes of the current study to consider whether, in fact, the letter or the application of the framework might actually be stifling innovation by raising barriers to entry, exit and mobility.

One of the potential problems here is obvious from the outset. If a regulated entity is expected to use its own judgments to decide how best to help achieve outcomes *consistent with the SRA’s objectives* (not the entity’s own objectives), that entity will need to have reasonably clear sight of what the objectives of the SRA actually are *in an operational sense* (what it is that drives SRA decisions). Among other things, this requires solicitors’ firms to have reasonably clear sight of how the SRA views what the LSB has referred to as the “overlap and interplay” among the objectives set out in the LSA²⁶; and it can be expected that a necessary, though not sufficient, condition for this to happen is that the SRA itself has clear and settled views on the relevant matters.

3.5.4. Risk based assessments

The SRA uses risk analysis as the basis for determining where to focus its efforts and attention. According to *Regulatory Risk Framework*²⁷ the SRA does not wish to eliminate all risks – which would be an impossible task – but to use resources to limit risk to acceptable levels and still enable the market to function flexibly.

Broadly speaking, and perhaps of most relevance to our study, the regulatory framework and application of the framework by the SRA appears to be motivated by the need to manage two over-riding categories of risk:

²⁴ Op cit.

²⁵ Solicitors Regulation Authority (2012), *Regulatory Risk Framework*, <http://www.sra.org.uk/sra/strategy/risk-framework/regulatory-risk-framework.page>

²⁶ Legal Services Board (2010), *The Regulatory Objectives*, http://www.legalservicesboard.org.uk/news_publications/publications/pdf/regulatory_objectives.pdf

²⁷ Solicitors Regulation Authority (2012), *Regulatory Risk Framework*, <http://www.sra.org.uk/sra/strategy/risk-framework/regulatory-risk-framework.page>

- Risks associated with the poor performance of legal practitioners (individual lawyers). The risks here are those associated with poor services/malpractice/misconduct/negligence, and are generally dealt with through sanctions imposed on individual solicitors, including the removal of the right to practise.
- Risks associated with poor or bad business management and business performance by a legal practice. The risks here encompass both illegal behaviour, such as embezzlement of client funds, as well as behaviour that is not illegal but represents poor business management and thereby increases the risk of consumer harm, including potential harm consequent on practice closures. This behaviour would be inconsistent with SRA principles and outcomes.

Two immediate comments on these two categories of risk are:

- They do not appear to us to be exhaustive of the major routes through which achievement of LSA objectives could be put at risk. Others include:
 - Risks to competition in consequence of the regulatory rule book, which is one of the two major reasons why self-regulation alone can be expected to be inadequate, and
 - Risks to the achievement of value for money in the provision of services to clients/consumers, which is the other major problem with self-regulation.²⁸
- Risk reduction alone is not generally regarded as a sensible working goal when ultimate objectives are not quantitatively precise. Normally we would expect to see a trade-off between risk and return: a little bit more risk might well be considered fine if it is associated with prospects for substantially better performance in terms of the ultimate objectives.

Most of the current regulations that affect entry, exit and changes to business structure can be rationalised in terms of one or other of the two categories of risks. We discuss the role of risk assessment later in the context of authorisation and supervision (see section 4).

There is a potential interplay between the two categories/types of risks insofar as it is arguable²⁹ that an individual in a failing law firm (for example, partners or the manager) may be more inclined

²⁸ We take it as a given that value for money, which takes account of both the services provided to or for consumers (whether by firms or by regulators) and the price the consumer pays, is a major aspect of the ‘consumer interest’ as that term is generally understood in UK regulation and competition law. Ofgem documents, for example, capture the notion under the masthead *Promoting choice and value for all customers*. Other regulators have slightly different formulations: thus the Legal Services Board has said that *The goal of the Legal Services Board is simple and clear – to reform and modernise the legal services market place in the interests of consumers, enhancing quality, ensuring value for money and improving access to justice across England and Wales* (LSB, Evaluation Framework, June 2011). In the economics of regulation, value for money is given precision via the concept of ‘consumers surplus’.

²⁹ As with many untested presumptions, care is required to avoid assuming that this is true. Adversity can sometimes call forth more effort and better performance, whilst a comfortable commercial life may induce

to provide poor service, provide bad advice, or act in ‘riskier’ and perhaps even illegal ways. In relation to law firms that have closed, the position is perhaps a little clearer since it can be expected that its clients will suffer to some extent, and the important question becomes *by how much?* Is it a matter of simple inconvenience, or are matters much more serious than that? Risks arising from delinquent performance of individual lawyers in previous periods when a closed firm was still operating are dealt with through the firm’s run-off insurance policy.

One implication of the interaction between the risk types is that there may be multiple regulations trying to deal with similar concerns. For example, regulations relating to authorisation may be primarily focused on ensuring that individual lawyers do not provide poor quality legal advice; but this type of risk is also subject to more targeted regulatory requirements and redress mechanisms (including, for example, claims against a practitioner’s professional indemnity insurance). Thus there are significant questions to be addressed around the general theme of whether or not existing regulatory arrangements establish a ‘belt and braces’ system for addressing relevant problems.

3.5.5. The public interest rationale for regulations

We found from our interviews that there was some confusion about what was the precise rationale for a number of regulations. More specifically, in relation to regulations or sets of regulations, it can be asked: precisely what is the harm that the SRA is attempting to avoid? Thus, there appeared to be a lack of clarity about the following sorts of questions:

- Are the regulations directed at preventing harm to the consumer, and if so, how does this interact with the compensation scheme that has been established?
- Are the regulations directed at preventing harm to competition, and if so, how do they relate to general competition law provisions?
- Are the regulations intended to prevent harm to solicitors collectively, for example, by trying to limit the amount of funds that are contributed to the Compensation Fund?
- Are the regulations directed at avoiding wider systemic or reputational harm which might arise should law firms not operate, and close, in an orderly manner?

In a number of cases the argument has been made that regulations are in place to protect the ‘public interest’. To date, we have not been able to identify any precise definition of what is meant by ‘public interest’ in this specific context. The European Commission³⁰ has encouraged national regulators to develop a clear understanding of what such terms mean, recognising that lack of transparency on how the objectives are defined and interpreted could lead to uncertainty about regulatory treatment and associated lack of confidence in the decisions being made. In this regard, we note that, in other areas of regulation, as in competition policy more generally, references to the ‘public interest’ have gradually been refined over time to identify various elements or components

the opposite. *Empirical* investigation of the links between financial pressures and consumer welfare is, therefore, exactly the kind of activity that a regulator taking a risk-based approach should be engaged in.

³⁰ European Commission (2005), *Professional services - scope for more reform*, September, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2005:0405:FIN:EN:PDF>

of the concept, or have been abandoned and replaced by more specific objectives (e.g. to promote and protect the interests of consumers, to facilitate or promote competition, and so on).

The underlying issue is that lack of clarity over objectives is a source of regulatory uncertainty, and such uncertainty is a factor that can have adverse effects on entry, exit and mobility.

3.5.6. SRA Handbook

The SRA Handbook³¹ sets out the standards and requirements that authorised and regulated legal entities are expected to adhere to on an ongoing basis. The requirements need to be met by the firm and by all individuals working within the firm. The firm must ensure that all employees are trained in the aspects of the Handbook that relate to their work, including non-solicitor employees.

The Handbook is long and detailed (over 500 pages) and is composed of three different types of standards and requirements:

- SRA Principles: These are the ten mandatory ethical and professional standards that all practitioners must adhere to. The principles underpin all other requirements.
- SRA Code of Conduct: The Code, which was put in place in October 2011, sets out mandatory outcomes that need to be achieved. The outcomes relate to client care, equality and diversity, conflicts of interest, confidentiality and disclosure, interactions with the court, introductions to third parties, management of the business, publicity, fee sharing and referrals, relations with the regulator, relations with third parties, and separate businesses. The SRA also provides ‘indicative behaviours’ to illustrate how the outcomes might be achieved, but emphasises that these are non-mandatory, and entities can meet the outcomes by other means. This is intended to be consistent with the general principle of outcomes-focused regulation.
- A set of requirements and rules relating to particular elements of running a regulated legal service business: These relate to (a) Accounts Rules; (b) Authorisation and Practising Requirements; (c) Client Protection (Indemnity Insurance); (d) Discipline and Cost Recovery; and (e) Specialist Services.

The SRA uses risk-based supervision and enforcement to monitor and manage compliance with the Code of Conduct and specific rules and regulations.

Since they are most relevant to our study, it is useful to list the different rules within the Authorisation and Practising Requirements and Client Protection Regulations (see Table 2).

Our analysis of potential barriers to entry, exit and changes to business structure primarily focuses on the requirements set out in Version 7 of the Handbook (dated 1st April 2013)³², although we do pick up on other aspects of the regulations where interview and/or survey participants highlighted

³¹ Solicitors Regulation Authority (2013), *SRA Handbook Version 7* (as of 1st April 2013), <http://www.sra.org.uk/solicitors/handbook/welcome.page>

³² Solicitors Regulation Authority (2013), *SRA Handbook Version 7* (as of 1st April 2013), <http://www.sra.org.uk/solicitors/handbook/welcome.page>

these as being relevant. We have reviewed all aspects of the Handbook but only discuss particular requirements below where we consider them to be relevant.

Table 2: Authorisation and Practising Requirements and Client Protection Regulations

Authorisation and Practising Requirements	Client Protection Regulations
A. SRA Practise Framework Rules 2011	A. Indemnity insurance rules
B. SRA Authorisation Rules for Legal Services Bodies and Licensable Bodies 2011	B. Indemnity (Enactment) Rules
C. SRA Practising Regulations 2011	C. Indemnity Rules
D. Solicitors Keeping of the Roll Regulations 2011	D. Compensation Fund Rules
E. SRA Training Regulations 2011 - Part 1 Qualification Regulations	E. Intervention powers (Statutory Trust rules)
F. SRA Training Regulation - Part 2 Training Provider Regulations	
G. SRA Training Regulation - Part 3 CPD Regulations	
H. SRA Admissions Regulations 2011	
I. SRA Qualified Lawyers Transfer Scheme Regulations 2011	
J. SRA Higher Rights of Audience Regulations 2011	
K. SRA Quality Assurance Scheme for Advocates (Crime) Notification Regulations 2012	
L. SRA Suitability Test 2011	

4. AUTHORISATION AND OUTCOMES BASED REGULATION

4.1. Introduction

As discussed in section 3.5.2, any entity that provides one or more of the reserved legal services to the public must apply to the SRA for authorisation. The authorisation can relate to a recognised body, a licensed body (ABS) or a sole practitioner. Within the authorisation it will be clear whether the firm is a sole practitioner, a company, a partnership or an LLP.

It is apparent that the requirement to obtain and maintain authorisation from the SRA is relevant to the following regulatory requirements and processes that straddle our study:

- obtaining authorisation from the SRA in order to enter into practice into one or more reserved legal services *de novo* (i.e. ‘entry’ issues);
- obtaining authorisation from the SRA for a new or successor business structure that may arise out of a merger or amalgamation with an existing legal practice (i.e. ‘mobility’ issues);
- ongoing regulatory requirements faced by solicitors’ practices in order to maintain their SRA authorisation, such as insurance (i.e. ‘exit’ issues).

Authorisation may therefore be considered an all-pervasive factor within our study since it permeates each of the core areas – entry, mobility and exit – and, in relation to entity regulation at least, a decision not to authorise a firm represents the ultimate sanction.

We explain here the process involved in applying for authorisation and how the SRA assesses an application. To the extent that a consistent approach to authorisation is taken both for new entrants and for established firms, this discussion also covers issues to do with SRA assessments in other situations, such as an amalgamation of practices that is accompanied by significant changes in one or more of business structures, business plans, financial arrangements and business governance. We also make some initial observations on the authorisation process, preliminary to more detailed assessment of the extent to which the requirement to obtain and maintain SRA authorisation affects barriers to entry, mobility and exit in the following sections 5 to 7.

4.2. SRA authorisation requirements

4.2.1. Applying for authorisation

Under the SRA Authorisation Rules for Legal Services Bodies and Licensable Bodies 2011¹⁴ the firm seeking authorisation has to submit an application form, along with relevant supporting documents, to the SRA. Supporting documentation may include a business plan, the track record of partners or proprietors (for example, if they have been involved with other authorised firms) and evidence of management systems and controls.

¹⁴ Solicitors Regulation Authority (2011), *SRA Authorisation Rules for Legal Services Bodies and Licensable Bodies 2011*, Rules dated 17 June 2011, <http://www.sra.org.uk/solicitors/handbook/authorisationrules/content.page>

The general idea is that the applying firm must ensure that it is willing and in a ready position to adhere to the regulations set out in the SRA Handbook. To demonstrate this, in the application form and supporting documents the applicant must provide information on various attributes of the planned business including the following:

- organisation details;
- details of regulatory history (including with other regulators);
- services to be provided (with details of business model and demonstration that it is sustainable);
- details of personnel (including ratio of qualified to non-qualified and fee-earners to non-fee-earners) and office arrangements;
- financial projections including balance sheet, estimated turnover and profit and loss, based on business plan predictions;
- details of systems and controls to support firm's activities and comply with SRA regulations;
- governance structure, including details of who will be appointed Compliance Officer for Legal Practice (COLP) and Compliance Officer for Finance and Administration (COFA), and details of any outsourcing arrangements;
- sources of finance;
- details of shareholders and managers (who need specific individual approval from SRA);
- details of professional indemnity insurance required and information on any cover held or any cases of the applicant body or the shareholder/manager being refused insurance in last five years; and
- details of how client money will be held, including how client money from legal activities will be kept separate from client money from non-legal activities in the case of an ABS.

Although this is a long list of requirements, much of the information is similar to that which would be gathered in any case when setting up a new business, at least if good practice is being followed. In some of the areas where the requirements go further than might be considered general norms, there are clear and specific regulatory reasons for doing so, the most obvious of these being the handling of client monies. In these two cases – information that would be collected in any case, clear and specific regulatory requirements (to protect client monies) – any disproportionate effects on entry barriers are likely to be associated with the efficiency of the administrative enforcement of the requirements rather than with the content of the regulations themselves. For example, although the information provided may be familiar to the new entrant – because the matters have been considered in developing business plans – it will need to be presented in a form suitable for SRA assessment; the SRA will need to familiarise itself with the relevant matters and then make its evaluation. This can take time, and interviewees have pointed out how costly such lost time can be in a situation in which a new entrant faces the task of getting several ‘ducks in a row’ (finance, insurance, personnel, marketing, etc.) in order to launch a business.

Where the rationale for a requirement is less closely connected to a specific issue – such as the requirement to provide details of business plans and financial arrangements – there is the further difficulty that it may be unclear to the entrant, and indeed unclear to SRA staff themselves, precisely how the information will be or should be evaluated. We therefore now consider these areas in more detail.

4.2.2. SRA assessment of authorisation applications

The application is assessed by the SRA and a decision is made within six months, with an option to extend to a maximum of nine months. We think these are extraordinarily long periods for applications that come from what, in a wider economic context, would be classified as very small businesses. A decision to reject an application can be appealed, but while an appeal can lead to a change in decision it cannot lead to recovery of lost time.

The SRA currently follows a five-step process in assessing an application. It:

1. Checks that the application is complete.
2. Carries out research on technical issues and risks associated with the application.
3. Evaluates the degree of risk posed by the application.
4. Makes a decision.
5. It issues a license and update records, If the application is successful.

In relation to steps 2 and 3, the SRA says that it considers what risks clients might face if the firm were authorised; whether the firm has competent people working in it; whether there is adequate supervision; whether there is sufficient funding and assurances of quality legal work; and whether the business model (including reliance on one client or one type of work) poses any risks. The SRA also considers whether the people running the firm have the required skills and experience and appropriate attitude to regulation and the best interests of their clients more generally; whether governance and risk management arrangements are sound; and whether business models have been tested thoroughly.³³

Again, by comparative standards, these risk assessments, which determine whether or not a business will be allowed to operate, represent an extraordinary degree of market supervision. Regulatory supervision is, of course, to be found in other professional activities, but it tends to be focused on professional conduct, not on general commercial matters: doctors and dentists are not required to present business plans in order to obtain certificates to practice. Similarly, detailed supervision of some types of business activity is to be found in other areas of regulation, such as environmental regulation and financial services regulation, but it is normally directed at a particular activity, product or service, where the linkage through to potentially harmful effects (on the environment, on consumers of the product) are relatively clear and direct, not at things like the governance or financial structures of firms, where the implications of different types of

³³ Details of the SRA's approach to authorisation are set out on its website at: <http://www.sra.org.uk/solicitors/firm-based-authorisation/our-approach.page>

arrangements are much less clear.³⁴ In the terminology of competition law, there is usually an obvious ‘theory of harm’ lying behind the regulatory interventions. A relevant question to be asked when considering the authorisation process, whether in the context of entry, exit (e.g. withdrawing authorisation on account of lack of insurance), or business restructuring (mobility) is: what is the ‘theory of harm’ underlying the decision?

In carrying out the third of the above five steps, the SRA uses a risk-index to evaluate whether and how to authorise, and later monitor, a legal service firm. There are 43 risks listed currently, although the list is updated on an on-going basis, covering a mix of business-specific and sector-wide risks. The risks are categorised as follows:

- firm viability and structure (including financial difficulty, inappropriate firm structure and structural instability);
- fraud and dishonesty (including dishonest misuse of client money or assets);
- firm operational risk (including breach of confidentiality and disorderly closure);
- competence, fitness and propriety (including lack of legal or financial competence);
- market risks (including competitive constraints and a changing regulatory landscape);
- external risks (including economic risk and technological risk).

We note the absence of any very obvious recognition in these risk categories of the interests/welfare of clients/customers. To the extent that these interests are encompassed by the above risk categories, the focus is on the nature of the services that are provided to consumers (roughly centred on questions of the quality and appropriateness of the advice and assistance that is given). Consumer welfare also depends on other things as well, however, most notably the fees that are charged for the services.

4.2.3. Rationale, benefits and costs of authorisation requirements

The SRA’s website page on ‘Our approach to authorisation’¹⁵ makes clear that the primary outcomes that it desires to achieve via the authorisation process are to:

- ensure public confidence in legal services provided;
- ensure the services are provided “to the required standard and in a principled manner”;
- ensure “those who own and manage law firms have the competence, character and willingness to achieve the right outcomes for clients and third parties”; and
- ensure only those firms and individuals that meet SRA’s criteria are authorised or approved.

³⁴ Whilst banking supervision might appear at first sight to be a counter-example, the chief concern about bank failure is not the effects it might have on the customers of a failing bank but rather the implications it may have for the stability of the banking system as a whole – the systemic risk problem.

¹⁵ Solicitors Regulation Authority (2013), *Our approach to authorisation*, <http://www.sra.org.uk/solicitors/firm-based-authorisation/our-approach.page>

The general overarching rationale for authorisation therefore appears to stem principally from a desire to protect the reputation of, and confidence in, the provision of legal services. It is true that consumer interests appear in the form of references to aspects of service quality, such as that services are provided to “the required standard”, and to achieving the “right outcomes for clients and third parties”, but whilst the notion of the ‘right outcome’ is arguably flexible enough to take account of a broad range of factors that might affect consumer welfare, we found no evidence to indicate that, in practice, there was any sense in which ‘value for money’ might be a desirable outcome for consumers.

4.3. Assessment of the authorisation process

4.3.1. A proportionate approach to authorisation?

The effect of a regulatory rule-book or framework depends as much on how the regulator applies the rules as on what is actually written in the rules. We have therefore considered, primarily through our interviews, whether the SRA’s authorisation approach is effective and efficient.

The broad approach to authorisation is intended to be similar for all business models and all types of law practised, but the SRA notes on its website¹⁹ that a proportionate approach may mean that some authorisation applications will get treated in a different way to others.

The SRA highlights particular types of application that would be considered lower-risk and therefore suitable for being fast-tracked. These include:

- legal disciplinary practices electing to become ABSs where there is no change in management or business model;
- changes to the legal entity (e.g. partnership to LLP) but no other changes to the firm;
- applicants intend to become corporate partners or managers of another recognised body but do not intend to provide legal services themselves.

Applications based on more complex and more innovative changes are, however, more likely to be subject to detailed scrutiny, and hence greater delay.

In our interviews, the need for an applicant seeking an initial ABS authorisation or seeking to operate with a non-standard law firm business model to show that they can get sufficient insurance cover has been described as a ‘chicken and egg’ problem. In order to obtain authorisation, it is necessary for the practice to demonstrate that it can take out insurance cover once authorised. Firms that have more ‘familiar’ business models commented that they did not encounter difficulties in obtaining insurance: *“We did not have problems obtaining insurance when we set up. Although we are not a ‘run of the mill’ type law firm, we ticked all the insurance boxes. As a two partner firm with no claims history we fit the mould, despite our non-traditional structure.”*

Insurance may be difficult to obtain, however, for a new business with a form that has not been previously authorised by the SRA, or where there may not be clear understanding of what parts of the business model are subject to regulatory requirements. Thus, among interviewees, the practice

¹⁹ Solicitors Regulation Authority (2013), *Our approach to authorisation*, <http://www.sra.org.uk/solicitors/firm-based-authorisation/our-approach.page>

that appeared to have the greatest difficulties obtaining insurance was an early, small ABS. It was pointed out to us that if, to expedite matters, such a firm goes so far as to pay for a policy ahead of authorisation, it risks paying a high rate for insurance that may turn out to be redundant.

4.3.2. Authorisation of alternative business structures

Our discussions with ABSs identified a number of potential concerns with the authorisation process. In particular, interviewees claimed that: there is a lack of accountability, the process is highly subjective, and the process involves significant time, cost and effort by the applicant.

Perhaps most significantly, some law firms indicated that they had considered applying to be an ABS but, having looked at the requirements, decided it was too difficult to pursue the application. In the words of one interviewee: *“We looked at becoming an ABS, but there were far too many hoops to jump through”*. This suggests that existing regulations may be creating a perception that applying to become an ABS is complex and burdensome, which in turn may chill interest in such applications, even by those firms/practices that might benefit from such an authorisation.

In contrast, in relation to non-ABS authorisations our interviewees imparted a generally positive perception of the process, although there were reservations to the effect that the volume and type of information requested tended to be excessive (see below). According to most of the relevant interviewees, the process for new law firm authorisations operates relatively effectively and applications are processed without undue delay.

Our interviews revealed many and often differing views as to the impact of ABSs on the market and on the practice of law, but we came to the conclusion that, in some respects, ABSs have become a lightning rod for a general cultural shift that is taking place in the market. In the earlier section on current trends perhaps the most striking statistic was the growth in incorporation as the preferred legal form for small solicitors’ practices. In our interviews with younger solicitors we were impressed by the apparent melding of traditional professional values with highly commercial approaches to the business side of things, particularly among those operating in market niches, which suggested that there was no necessary conflict between the two. At the same time, there seemed to be widespread recognition that many older, traditional, small practices were lacking in business skills, reflecting the rather different market conditions of earlier times.

Thus, whilst our general view is that the authorisation process is disproportionately restrictive in the way that ABS applications have been processed to date – we leave open the question of whether this was an initial hiccup that is on its way to being resolved, for want of sufficient evidence at this time – the greater commercial skills of a younger generation of solicitors have found ways around this potential barrier to entry. This is perhaps best exemplified by those of our (small firm) interviewees who had looked at the ABS option, had decided it was too difficult, but had proceeded with their plans via innovative adaptations of other organisational alternatives.

In relation to the sources of the disproportionality, we spoke with one private equity investor in a relatively large law firm that had taken the ABS route. Although the ABS was ultimately approved, the process took almost a year to complete, despite the applicant forewarning the SRA of the imminent application and urging the regulator to seek appropriate expert advice. It was said that significant time was spent educating the regulator on the buyout structure. Although the SRA made

clear that it was not its purpose to vet the individual business plan, the applicant was of the view that the process did, in fact, come very close to such vetting, leading the applicant to wonder “*whether they strayed beyond their remit*”. It was reported that “*They looked at aspects of our business model which did not seem to be that relevant to our fitness to be owners of a legal services firm*”. In this case the applicant said that it would not be deterred from investing further in the sector. However, others may be more easily put off if there is a perception of unnecessary caution or ‘red tape’ in the process, and, as already indicated, we encountered more than one interviewee who said that they had looked at an ABS option and had decided against it, on grounds of regulatory complexity.

4.3.3. Authorisation of sole practitioners

A number of the mandatory outcomes relating to running a solicitors’ business are potentially onerous for a sole practitioner or small partnership and have the capacity to create barriers to entry, mobility and exit, as well as to increase costs more generally. Whether or not they do so in practice is largely determined by the way in which the SRA regulations are enforced for small businesses.

Our feedback from interviewees revealed a rather mixed picture regarding the impact of regulation and approval procedures on sole practitioners. We have spoken to sole practitioners who were basically satisfied with the process. However, we also had feedback that pointed to a number of shared concerns:

- One solicitor who has been a sole practitioner for almost thirty years discerned an increase in the regulatory burdens on sole practitioners over time. Reflecting that it was more straightforward when he started out, he believed that it was not easy for sole practitioners starting out today: “*Even after you have filled in the forms, answered the many questions and waited for your application to be processed, you may fail at the last hurdle because they are not convinced. It takes stamina and resilience to get off the ground. This has nothing to do with your legal skills. It is about whether you can navigate the process.*”
- Another sole practitioner solicitor who was in the process of completing her authorisation did not have specific complaints but was finding that the procedure was taking up a disproportionate amount of time. She remarked that she was “*about three quarters through*”. What was holding her back, she said, was not a lack of drive to set up her own business but a lack of clarity on exactly what information – and how much of it – the SRA was seeking. She was reluctant to ask directly in case she got the “wrong answer” or reluctant to send in the form in case it was rejected. Thus she felt she was in a kind of limbo, not knowing what to do next because she felt unable to engage with the regulator directly, anticipating an unhelpful response.
- It was said that some sole practitioners had adopted the ‘solo route’ more by necessity than desire, finding that there was no longer a role for them in a larger law firm. This may have been due to the niche nature of their particular interests and specialisms, their existing firm being in financial difficulty, or seniority dictating that they move on against the ‘up and out’ culture that can prevail in the larger firms. With pressures on in-house budgets, in-house career progression may not be available at all, forcing many to pursue an alternative.

Whilst the sole practitioner route remains viable it acts as an option that provides an existing source of flexibility and adaptability in the market, and this can help explain why new entry rates have remained so high in a period of increasing financial pressures in the market. There can be real potential benefits to consumers from this in that, instead of leaving the market entirely, as may happen in some economic sectors when larger firms contract, supply capacity remains in the market, exerting a general downward pressure on prices. Similarly, some of the feedback we obtained from providers of legal outsourcing services was that many of the lawyers seeking to go freelance with them had done so because they found the authorisation process “*too much headache*”.

4.3.4. Maintaining authorisation

Before we conclude our preliminary discussion of the role of SRA authorisation we note that this regulatory requirement is not a ‘once and for all’ issue in the sense that, once authorised, a firm is able to remain in practice at its own discretion. The continued requirement for SRA authorisation in order to remain in practice has two particular manifestations in the solicitor profession.

First, the SRA has at its disposal a variety of tools to seek to ensure compliance with regulatory requirements, with withdrawal of authorisation as a potential ‘last’ measure. Rule 22 of the Handbook provides the SRA with a detailed list of grounds for suspending or revoking an authorisation. These range from occurrences one would expect, such as insolvency events, to the firm’s failure to meet obligations in respect of compliance officers, management and control. Moreover, it is open to the SRA to suspend or revoke an authorisation if “*for any other reason it is in the public interest*”.

These backstop powers of the regulator to withdraw an authorisation – whether on a temporary or permanent basis – are the archetypal powers of a regulator. Based on our interviews with regulated firms and the SRA, we did not identify any reasons to believe that the SRA’s approach to, or exercise of, such a powerful option operated as an impediment to entry or mobility within the profession (e.g. because such a threat makes entry more risky). What we found was a preference on the part of SRA to proceed by encouragement and escalation of engagement with firms, only using the threat or actual withdrawal of authorisation where other means have failed (what might be termed ‘activist supervision’). This is subject to the overriding caveat that where fraud or other activities that prejudice clients’ interests or client monies are discovered, the SRA would not hesitate to intervene and close down a firm.

Second, the regulation of solicitors’ services is unusual³⁵, although not unique³⁶, in subjecting firms to the requirement to maintain prescribed and relatively onerous minimum terms and conditions for insurance in order to retain their authorisation. This requirement was summed up in a recent article in *The Lawyer* which said that:

³⁵ In comparison, for example, with the skills listed in the EU Regulated Professions Database or, more obviously, service firms more generally.

³⁶ For example, self-employed barristers are required by the Bar Standards Board to have professional indemnity insurance to practise. This is provided by Bar Mutual a not-for-profit organisation which insures the entire profession.

“Unlike architects and accountants, lawyers are required to have in place a standard insurance policy at all times – be they a one-solicitor high street firm or a 150-partner City litigation firm.”³⁷

The relationship between authorisation to practise and insurance is stark: there is no authorisation without the prescribed level of insurance being in place. We note, therefore, that the inability to renew cover may serve to precipitate a firm’s exit. Whilst this cannot be viewed as a barrier to exit – it is actually forcing exit – it can properly be regarded as a barrier to mobility, because it has the effect of prohibiting business strategies that depend upon the possibility of operating for a period without insurance, or of operating for a period with insurance that does not meet the conditions specified by the SRA.

Prima facie this appears disproportionate in terms of LSA objectives (see further below), but again much depends on how flexible the SRA is in enforcing the requirement. We are aware of at least one incident where, in the build-up to the 2010 renewal date, Ukraine-based insurer Lemma increased capacity and wrote more than £6.2 million worth of UK cover in the relevant year. By the 2011/12 renewal date, it insured just one UK law firm. It appears that when Lemma went insolvent the SRA gave the remaining law firm extra time to find new cover rather than revoking the firm’s authorisation with immediate effect.³⁸ However, our overriding feedback from interviews was that the requirement to maintain insurance as a ‘condition’ of continued authorisation is, in general, strictly enforced. We return to this issue in sections 6, 7, 8 and 9, in particular when considering the proper boundaries of SRA regulation, given the existence of other checks and balances exerted by other bodies, including insurers.

4.3.5. Interim conclusion on authorisation

The SRA’s regulatory role as regards authorisations affects entry, mobility and exit barriers in a number of different ways and varies in intensity according to the choice of business model. Unfamiliar business models and structures can be expected to attract more regulatory interest, creating a risk that the threat of not being able to achieve authorisation, or of having authorisation withdrawn (e.g. as a result of changes in business models and structures at the time of an amalgamation), might serve to chill innovation.

Powers of authorisation are not uncommon in regulated sectors of the economy, but the degree of engagement of the SRA with the business activities of legal practices is highly unusual, particularly when account is taken of the fact that the great majority of solicitors’ practices are very small businesses. This engagement starts with a first application for authorisation (at the entry stage), but is a feature of the situation for the entire lifetime of a regulated business, affecting both mobility and exit decisions. We would, therefore, expect to see clear and demonstrable benefits from the approach taken to warrant such a high level of supervision of small business models, structures and finances; otherwise it is hard to see how the approach can be seen as anything other than disproportionate.

³⁷ Professional indemnity special (2013), *The Lawyer*, 29 July.

³⁸ *Ibid.*

Similarly the threat of withdrawal of authorisation in the event of failure to be able to obtain insurance of a type that is prescribed by the regulator is unusually draconian. Whilst it is not necessarily enforced in a very rigid way – the SRA has shown a propensity to take account of difficult circumstances in the insurance market – there are nevertheless grounds for suspecting that the strength of the linkage is sufficiently strong to give rise to risks of harm to consumers and to competition. Consumer harm may occur through the immediate and direct effects of closure of a firm (for want of the required insurance) that could otherwise have continued to operate in a satisfactory way. Harm to competition may occur since, other things equal, the insurance requirement may serve to reduce the number of firms operating in the market for solicitors’ services. The necessity to obtain prescribed insurance cover also serves to reduce the overall market elasticity of demand for insurance – at the level of the individual practice this manifests itself as reduced bargaining strength when trying to negotiate terms – which is an effect that tends to weaken the intensity of competitive constraints in the insurance market itself.

The SRA documentation suggests that the prime motivation of the authorisation process is desire to protect the reputation of, and confidence in, the provision of legal services. Matters such as the implications of authorisation decisions and criteria for competition and for consumer welfare in a general sense, not just consumer interest in the quality of the legal services provided, do not appear to loom large. More specifically, the notion of ‘value for money’ as a major contributor to consumer welfare, and as a major benefit of competition, is notable by its absence. Indeed the notion that there might exist risks to achieving value for money for consumers appears to be off the regulatory radar, although it might be argued that mandatory outcome O(1.6) is at least an approximation to a more consumer focused approach.

O(1.6) states that:

“you only enter into fee agreements with your clients that are legal, and which you consider are suitable for the client's needs and take account of the client's best interests;”

It is far from clear, however, what is meant by a fee agreement that is ‘suitable’ for the clients ‘needs’; or what ‘take account of the client’s best interests’ means in terms of actual behaviour. On what criteria is the ‘suitability’ of a fee agreement to be judged? And in what circumstances could it be said that a fee arrangement does not take account of a client’s best interests? The meanings and intentions are far from clear and transparent.³⁹

In relation to the requirement for insurance, one interviewee spoke of the possible ways in which the non-availability of affordable insurance could close down a law firm business:

“My biggest bug bear about insurance is the regulation that dictates that you can be closed down if you cannot get cover. Lawyers face this threat every year. I am not aware of any other profession that has the same sword of Damocles hanging over them. I think it is a bizarre situation where the insurers are essentially acting as a decision-maker on which law firm survives or dies. They are not the regulator but they have become de facto gatekeepers to the market”.

³⁹ We understand that the provision was originally designed with arrangements such as contingency fees in mind, which underscores the point that the regulations do not address the centrality of value for money for consumers, and hence appear to be somewhat removed from the relevant consumer objective in the LSA.

We return to the issue of insurance throughout this report in each of the specific contexts of entry, mobility and exit and in our overall assessment in section 8. We also return to mandatory outcome O(1.6) in section 9, where we consider alternatives to the current arrangements.

4.4. Outcomes-based regulation

4.4.1. Assessment of particular outcomes

The Code of Conduct in the Handbook provides details of the mandatory ‘outcomes’ that all authorised firms must meet to become and remain authorised. Since it is these ‘outcomes’ that provide the rationale for regulatory intervention, such as a decision not to authorise a particular firm, their significance for wider objectives is of importance in assessing the proportionality of the relevant interventions. We therefore comment on the significance of each category of ‘outcome’ in Table 3 below.

Our conclusion is that, at a general level, most, though not all, of the categories do not appear to give rise to particularly onerous or avoidable regulatory burdens. However, those ‘outcomes’ that are expressed in terms of business models or firm governance or financial structure seem to us to be of a different character to the others, and to give rise to questionable regulatory approaches. In particular, and as already foreshadowed, they seem to us to be much less directly connected to the objectives of the LSA than the other outcome categories, and indeed may, by potentially having anti-competitive effects, not least by raising barriers to entry for at least some types of firm, actually impair achievement of some LSA objectives.

Table 3: Assessment of outcomes by category

Outcome category	Comments
Client Care (1.1 to 1.16)	The outcomes are consistent with what would be expected for a professional services firm operating in an effectively competitive market, and would not be expected to result in significant or unwarranted costs for a business. Failure to meet these outcomes would be expected to lead to a firm having to exit as it would not be meeting the requirements of its clients. However, in an effectively competitive market, suppliers would also be expected to provide ‘value for money’. In the absence of attention to this additional ‘outcome’ there is a risk of gold plating and excessive fee levels, sustained by the prevention (by regulation, in the name of ‘client care’) of business strategies that would offer better value for money.
Equality and Diversity (2.1 to 2.5)	These appear reasonable and in most cases mirror or clarify wider legislative requirements of firms across the economy as a whole.

Outcome category	Comments
	They are unlikely to impose any significant additional cost on a legal services firm.
Conflicts of Interest (3.1 to 3.7)	Important for protection of the interests of clients and the reputation of individual firms and the wider judicial system.
Confidentiality and Disclosure (4.1 to 4.5) ¹⁷	These ‘outcomes’ appear reasonable and are consistent with providing the quality of service required in the legal profession. They do not appear overly onerous given the nature of information that solicitors’ firms hold and the significance of the relevant matters to clients.
Your client and the Court (5.1 to 5.8)	These outcomes apply to litigation and advocacy work. They are consistent with what would be expected for the provision of professional service in this area. There does not appear to be a significant cost or burden related to meeting this outcome.
Your clients and introductions to third parties (6.1 to 6.4)	These ‘outcomes’ are in place to ensure that legal service providers retain independence from other parties (e.g. financial service providers). It is possible that it will be more difficult for a new potential entrant ABS firm to demonstrate to the satisfaction of the SRA that it can meet the relevant requirements, given that ‘third party’ activities are being undertaken within one entity. However, the issue is by no means unique to ABSs, and significant differences in the treatment of different business structures at the stage of authorising a new entrant may be disproportionate.
Management of Your Business (7.1 to 7.9)	These ‘outcomes’ appear to be consistent with good practice business management and in many cases would seem to be similar to what a registered company needs to do under company law. Whilst their achievement is not necessarily burdensome, there are substantive questions to be asked about what legal services regulation is seeking to achieve by specifying them. Are other aspects of the law considered inadequate, for example? More fundamentally, what is and what is not good management is something that, in a competitive market, gets determined by the competitive process itself. To the extent that a regulator takes a different view on such matters, economic history suggests that, much more likely than not, the result will be harm to competition and to the interests of consumers, contrary to LSA objectives. To the extent that regulatory and competitive markets views

¹⁷ The outcomes apply to all members of a firm and apply after the end of a retainer and after the death of a client. Additional protections are required where two or more firms merge or an individual leaves one firm to join another.

Outcome category	Comments
	coincide, there are questions to be answered about whether regulation is simply duplicating, at extra cost, the functions served by other institutions (e.g. competitive markets).
Publicity (8.1 to 8.5)	Although there may be some overlap with more general advertising regulations (for example, as set by the Advertising Standards Agency) the outcomes in themselves are unlikely to impose significant additional regulatory burden on authorised firms.
Fee sharing and referrals (9.1 to 9.8)	These outcomes appear broadly reasonable given the need to protect the quality and independence of legal advice. As with outcomes relating to ‘Your clients and introductions to third parties’ (6.1 to 6.4) there may be a question as to whether it is more difficult for a new ABS to demonstrate that they can meet this outcome when seeking authorisation.
You and your regulator (10.1 to 10.13)	These outcomes are primarily about regulated firms meeting information requests from the SRA and/or the Legal Ombudsmen. The real test of how onerous the requirements are depends on how much and how frequently the SRA seeks information and the extent to which attempts are made to manage regulatory burden in a manner that is consistent with ‘Better Regulation Principles’. ¹⁸
Relations with third parties (11.1 to 11.4)	The outcomes are in place to ensure that a regulated firm does not try to take advantage of others. The outcomes appear reasonable given the issues at stake.
Separate businesses (12.1 to 12.6)	These outcomes affect organisations where one business provides services that are not authorised by the SRA or another approved regulator. These separate businesses are permitted to do some activities that are ‘solicitor-like’ in nature but are not covered by the same protections as the services undertaken by an authorised business. Authorised businesses cannot share information with these separate businesses without the permission of the client. These outcomes affect ABSs in particular and appear in many ways to reinforce other outcomes (e.g. relating to client confidentiality and client care). There is some evidence that they are significantly affecting business structure decisions (see the penultimate bullet point in 4.4.2), and they have a potential to restrict innovative organisational developments.

¹⁸ See, further, Better Regulation Delivery Office at <http://www.bis.gov.uk/brdo/resources/knowledge/better-regulation-principles>. Sir Philip Hampton’s 2005 review, *Reducing administrative burdens: effective inspection and enforcement* considered how to reduce unnecessary administration for businesses, without compromising the UK’s regulatory regime.

From our interviews it appears that the rules which present most challenges from a compliance perspective are those that deal with third parties (11.1 to 11.4), which are intended to ensure that regulated firms do not take advantage of their relationships with third parties. Whilst they recognised that some referral arrangements are permitted, several firms told us that they have turned business away or felt they had to walk away from business where the other party was seeking a referral fee. Even in circumstances where they felt that they could achieve the relevant outcome and ensure that their independence was not compromised, they had turned business away “*out of an abundance of caution*”.

We note that the relevant rules may bear down disproportionately heavily on new entrants, since it is these practices that are faced with the necessity of building up a client base, and hence are particularly dependent on seeking out new clients. Thus, whilst the rules are understandable in view of the issues at stake, it may be worth considering the situations in which legitimate referral arrangements could be justified.

Our general reading and interpretation of the mandatory outcomes in the SRA Code of Conduct suggests that the outcomes themselves are unlikely to create substantial *across-the-board* regulatory barriers to entry, exit or changes in business structure for traditional legal services. However, given the importance of new entry for experimentation and innovation in markets, even modest, additional costs of entry can have non-trivial effects on market flexibility and adaptability. Further, as discussed, some of the ‘mandatory outcomes’ do appear to be potentially inimical to non-traditional business models, the most obvious being those dealing with business and financial matters.

4.4.2. Other relevant sections of the SRA Handbook

In Table 4 we set out our understanding of the rationale for other relevant sections of the Handbook that affect authorisation and hence entry decisions. We also set out the benefits and costs associated with each relevant section of the Handbook. We have focused attention on those areas of the Handbook that appear to be most relevant for the assessment of entry regulatory requirements and which have some potential for creating a regulatory burden. In many cases the details in the Handbook did not suggest a regulatory requirement was creating any additional burden beyond normal business practice (and in some cases the requirements were reinforcing other regulations mentioned here). However, as indicated above in section 4.3.2, some interviewees did note a preoccupation on the part of SRA with business and financial matters and this was particularly prevalent in the authorisation process. This does not however appear to be driven by specific elements of the Handbook.

The comments in Table 4 are based on our (desk research) reading of the SRA requirements and views we have heard from stakeholders in our interviews. We do not list the individual rules and requirements as we do not think the assessment would change significantly if we go down to this level of detail. However, we do highlight where the benefits and costs may vary depending on the type of authorisation that is being considered.

Table 4: Assessment of the SRA Handbook

Section of Handbook	Rationale	Assessment
<p>SRA Accounts Rules 2011</p> <p>These apply to all employees of a recognised body. For a multi-disciplinary practice they only apply to legal and reserved activities.</p>	<p>Safeguarding client money</p>	<p>The rules protect consumer interest and it is relatively easy to monitor compliance (detailed ‘tick box’ rules).</p> <p>There are some costs to compliance, for example relating to accounting processes and retention of records.</p> <p>Guidelines appear broadly reasonable and consistent with what would be expected for any organisation holding and managing money of others.</p>
<p>Authorisation and practising requirements</p>	<p>Ensuring authorised firms and their employees are trained to sufficient standard to meet broad set of SRA requirements</p>	<p>The requirements in this area are designed to ensure quality of service and are broadly consistent with other professions such as accountancy and dentistry.</p>
<p>(a) Practise Framework Rules 2011</p>	<p>Protect clients and wider public by providing restrictions on types of business that can practise</p>	<p>These requirements define different types of business. The framework rules do not appear to create any barrier.</p>
<p>(b) Authorisation Rules for legal services bodies and licensable bodies 2011</p>	<p>Ensure applicants are in a position to meet other SRA rules and thereby protect consumer interest.</p>	<p>These requirements provide clarity on the authorisation process. The costs involved are the fee to apply and the ongoing SRA fee if authorised. Firms will also incur costs filling out the form and responding to SRA queries on the application.</p> <p>The guidelines are primarily concerned with providing clarification on what the SRA looks for in an authorisation decision. For example, the applicant does not have to have all the</p>

Section of Handbook	Rationale	Assessment
		insurances and other elements needed to meet the rules in place and paid for, but it does need to show that they will be able to comply when they are authorised (e.g. by having an agreement in principle from an insurance provider).
Client Protection Regulations	Protect against negligence and dishonesty	Broadly consistent with what we observe in other professional sectors. Consistent with quality of service requirements to be provided by a legal services firm.
SRA Indemnity Insurance Rules 2012	To provide a further level of protection for clients/consumers.	Standard practice for professional services to have indemnity insurance, but there are issues to do with the scope of the insurance that is required, which could raise costs of entry. It is likely to be more difficult for an ABS or other non-traditional business model to show that they will be able to get insurance when seeking authorisation.

In relation to the information gathered in interviews which helps inform the above comments, it can be noted that, as with the feedback on outcome-focused regulatory approaches, we found a rather mixed set of views. To summarise briefly:

- Rule changes: Several interviewees remarked that they had lived through various incarnations of professional regulation. The latest round was “*revolutionary*”. There was a need to let it “*bed down*”. Too much change for its own sake was not good unless there were palpable failings.
- Volume of regulation: Sole practitioners or firms with fewer than 10 partners tended to the view that there was too much regulation. One practitioner who has been at the same High Street firm for almost twenty five years said he was “quite fed up with it”. The concern was not purely a complaint about the extra cost and human resource burden.⁴⁰
- Regulation as a risk: The previous concern about the volume of regulation and a Handbook over 500 pages long pointed to a deeper issue that too much regulation might in fact be a risk factor. One COLP put it to us that the danger with so much detail and volume is that this can encourage an ‘ostrich mentality’ when people are actually in denial of what really matters because they are afraid to confront what appears to be a “morass of rules which no one cares about or even knows what they are”.
- COLP/ COFA: The COLP requirement was viewed as particularly onerous and resource-intensive by several smaller firms. We heard on several occasions that this was effectively a part-time job in itself which put strain on small firms given the need to appoint a member of senior management to the role. There was no general desire to outsource this function expressed by interviewees since they felt that they could never truly delegate such responsibilities, and that ultimately the senior lawyers were the repository for the relevant information. However, one small firm did in fact outsource the function and believed that the extra expense was well worth it, given the time that it freed up for concentration on the main activities of the firm.
- Knowledge and understanding: We identified varying levels of knowledge of what was in the rules themselves. One COLP claimed to be knowledgeable about the regulatory requirements, but confessed to having trouble “keeping up” with changes in the requirements (in line with a finding in other studies of the burden of regulation, to the effect that the rate of change of regulation has a significant, independent effect, over and above the effect of the *level* of regulation). Another interviewee with over ten years of practice confessed to struggling with the detail because, although the existence of rules in the Handbook were known, “it had never been necessary to look at them”. The same individual was aware of the two compliance roles (COLP and COFA) but asked us for a reminder of what the acronyms meant.

⁴⁰ This is consistent with other studies of the burden of regulation on small firms. Proprietors complain of the distracting effect of regulatory compliance, implying that it leads to a diversion of attention away from the main business of a firm and thereby imposes costs over and above those normally measured by the time and money devoted to compliance. The phenomenon is a variant of the ‘Penrose effect’, introduced in section 5.2 below.

- **Impact:** Interviewees also expressed different views as to how they expected the rules to affect various firms. Most firms felt that they were well-managed and that helped them comply with the changes. The same firms felt that less well-managed firms might cut corners because the total package seems rather “overwhelming”.
- **Compliance:** One interviewee remarked that while the larger firms seem to have “armies” of compliance teams, in their experience the lawyers themselves had a surprising lack of understanding of the actual rules. It was also regretted that such firms seem to have a rather flexible approach to conflicts and they speculated whether smaller firms “would get away with” the same approach.
- **Material breach:** One interviewee, a partner in a two partner firm, saw SRA regulation as inflexible when there was no materiality threshold for the level of breach that needed to be reported. He found it “absurd” that an accounting error of a matter of one pound would need to be reported yet the time spent detecting and documenting such an error could be multiples of the amount at stake. He urged a “common sense” materiality threshold be introduced and believed that this was consistent with the spirit of outcomes regulation.
- **Impact on (larger) multidisciplinary firms:** Although the outcomes are mandatory as regards all regulated firms with no relaxation as to the type of firm, we found in our interviews with multi-disciplinary firms that regulation could be a significant driver in the choice of business structure. This could lead to firms electing not to form an ABS even if that would bring business benefits and competition. This point is best illustrated by contrasting the position of two multidisciplinary practices weighted towards the accounting sector:

Firm A formed a separate LLP entity which is regulated by the SRA. Although it operates under the same brand as the multidisciplinary accounting and consulting practice, it is a separate business subject to separate regulation. The accounting/consulting business is not subject to SRA regulation.

The legal activities of Firm B remain part of the corporate structure of the multidisciplinary practice. It has an integrated legal services practice which provides advice on legal issues as part of the client service team. This covers the following core areas: tax; litigation; corporate. The firm considered a number of business structures, including setting up a separate legal services business. It commented that the current structure is driven mainly by regulatory factors. The additional (SRA) regulation that would apply to the entire multidisciplinary regulated practice was an impediment to seeking status as a regulated law firm. The firm also noted the benefits of remaining part of an integrated business, which would be lost if they set up a separate structure for the legal services function: *“Cultural and operational integration through [Group] is key to the integrated offering we present to clients. It is also important to employee management and technology synergies. A lot of this would be lost if the law firm were a separately managed regulated entity.”*

- Other professions: When contrasting SRA regulation with the rules in other professions one multi-disciplinary firm observed that the solicitor rules tended to be overly prescriptive and inflexible. Contrasting the approach in the accountancy profession they cited the following rules as particularly onerous: conflict of interest (own conflict rules), insurance requirements in general, and run-off insurance requirements in particular.

A number of these points are consistent with previous Regulatory Policy Institute studies of the burden of regulation in other sectors of the economy. These include the views that: it is the rate of change of regulation that causes the biggest burdens; there is too much regulation; the volume and rate of change of regulations creates risks for companies in that it can be difficult for them to determine whether they are complying or not (a problem that is likely to be exacerbated by ambiguities in outcomes-focused regulation, and that is likely to present more difficulties for smaller firms); and other, less well-managed firms were suspected of cutting corners to gain competitive advantage.

5. ENTRY

5.1. Introduction: specific issues arising at the entry stage

As explained in section 3.5.2, to be able to operate as a regulated legal services firm an entity must be authorised by the SRA, and the general authorisation process has been described in Section 4. Barriers to entry in legal services markets have been analysed by others in recent years, at both national and European level, and we summarise those of the findings of some of the main research reports that are in the public domain. We have taken account of this research to the extent that it is relevant to our assessment.

When deciding whether or not to enter a market, newcomers should rationally consider the prospects of facing future constraints on changing business structure and/or exiting the market. For example, if there is a chance that the firm will want to change its business structure at some future date, the extent to which this is perceived to be costly or difficult should influence the original entry decision; and this is just one aspect of the entanglement between barriers to entry, exit and mobility discussed in section 2.1.

Whether such foresight is widely exercised in the market for solicitors' services, particularly when new entrants are small in size (as the great majority are) and when regulatory arrangements are in a state of transition, rendering it difficult to evaluate future constraints on mobility and exit, is another matter. Discussions during interviews suggest not. Nevertheless, for completeness, it can be noted that the analyses in sections 6 and 7 on regulations affecting business structure changes and exit are also relevant when considering whether regulations potentially deter entry.

At the end of Section 4 we noted that a number of points raised during the interviews were familiar to us from previous Regulatory Policy Institute studies of the burden of regulation for small firms, including that it was often the case that the rate of change of regulation imposed bigger burdens on small firms than the level of regulation. Over time, businesses gradually become familiar with an unchanging 'stock' of regulation, but keeping abreast of new regulations and their implications requires continuing time and effort.

For many new entrants, all or most regulatory requirements are likely to appear as 'new', so that, for these firms, a high *level* of regulation translates into a high *rate of change* of regulation: the more regulation there is, the more there is to learn. Thus, perhaps counter-intuitively:

- Detailed and complex regulatory requirements which are stable over time create entry and exit barriers because they are a sunk cost that creates an asymmetry between newcomers and incumbents: the requirements will be new to the entrants but familiar to established firms.
- Detailed and complex regulatory requirements that are in a state of flux will raise costs of doing business generally, but they will be less of an entry barrier since established firms will, like entrants, have to devote significant resources to learn about the latest set of requirements.

For obvious reasons, however, we do not advocate permanent revolution in regulation as a means of reducing entry barriers!

Finally, by way of introduction, we note that assessments at the point of entry may be more than usually vulnerable to a behavioural or cognitive bias in the way in which ‘sins of commission’ and ‘sins of omission’ are evaluated. If an entrant is authorised and subsequently fails in a way that gives rise to consumer harm (i.e. a ‘triggering event’), the failure and its associated harm can be traced back to a ‘causal’ decision *of the regulator*, the decision to authorise. This gives rise to risks of negative consequences for those involved in the authorisation decision.

Suppose, however, that an entrant with an innovative business model is denied authorisation. Suppose further that the business model would have led to better value for money for its clients and, in consequence of this and of the wider adoption of the business model by others, competition in the market would have been intensified. In this case, just as much as it is in the case for our hypothetical, failing firm, consumer harm can be said to have been ‘caused’ by the authorisation decision (or, in less definite language, the authorisation decision led to a situation in which harm was caused). The harm is the result of the prevention of benefits (to consumers directly and, via competition, to consumers indirectly) that would otherwise have eventuated in the counterfactual position (authorisation granted).

The example is another illustration of the relevance of the concept of an *economic* cost, with which we opened this Report. Economic cost is measured as the value of what is given up. In the example, what is given up by denial of authorisation are the benefits that would have flowed from the new business model or strategy. In principle, these should be balanced off against the costs of failure in the relevant assessment: it is true that the business might fail and that consumers might suffer if it does; it is also true that the business might succeed and that consumers might benefit if it does.

It is particularly important to recognise the ‘upside’ to new entry since, as a matter of empirics, new entrants are often a major source of innovation and progress in markets, at all levels and in all sectors, not just in the most obvious and best known cases such as Intel, Microsoft, Apple, Google, Amazon, et al. However, regulatory incentives tend to be such as to favour its neglect. If authorisation is denied, there will likely be no ‘triggering event’ at a later date which will start a trail leading back to the authorisation decision itself. Regulatory incentives therefore tend to be asymmetric: get it wrong in one ‘direction’ (authorise a firm that fails) and decision makers may be held to account, get it wrong in the other direction (deny authorisation to a firm that would have succeeded) and likely no one will notice. The result is the familiar, excessively risk averse behaviour of many regulatory bureaucracies.

We have seen and heard little that suggests a general awareness of this potentially major issue.

5.2. General assessment of the purpose and effectiveness of entry rules: the implications of risk-based and outcomes-focused regulation

The risk-based approach is at the heart of the authorisation regime and therefore can be expected to affect entry decisions (and also decisions to change business structure which result in the need for a change in authorisation). As stated earlier, the new approach to regulation is still in its infancy and we recognise that it may take time for the transition to be made, particularly in the practical tasks of developing effective administration and enforcement.

The new framework is intended to encourage companies to focus on delivering the ten mandatory principles in the SRA Handbook and to manage the business risks associated with doing this; and our first major comment on these intentions is that both the objectives and the perceived links between regulatory requirements and outcomes are rather vague and imprecise in nature.

Second, it is unclear that the SRA is an organisation that is well adapted to the task of assessing the business models and financial plans of small businesses. These are tasks that normally fall to institutions such as banks and insurers.

Third, the approach to risk has been developed in terms of the risks to the achievement of the SRA's objectives in general, not as risks to consumer welfare or to competition.

Finally, the SRA risk-index appears to be quite prescriptive in identifying business-specific and industry risks. One tendency that can be expected from such an approach is that businesses will be encouraged to focus on managing the risks identified by the SRA rather than necessarily managing their business in the most effective way. Any regulatory list, including the risk-index, creates a focal point and can, over time, come to resemble a rules-based compliance list. It therefore does not sit easily with the general idea of the outcomes-based approach to regulation and may stifle efficiency and innovation in the sector. More specifically, for the purposes of this study, the focus on these specific risks may discourage companies from developing new forms of practice where they are concerned that they cannot demonstrate *ex ante* to the SRA that they can manage the risks. This could, for example, arise in the context of applying for an authorisation for an ABS (particularly if the business model is unfamiliar), but the issue is by no means restricted to ABSs.

On the whole, our interviews revealed general support for the intentions behind a move towards a more flexible and less prescriptive approach which focused on results rather than black letter rules. A number of interviewees felt that for well-managed firms the move to outcomes-focused regulation did not make much difference because they would be compliant anyway. Some interviewees saw benefits in putting pressure on firms to think through their procedures because *“it means that there are fewer places to hide for the badly managed firms or sloppy firms. They need to show that the steps they have followed were conducive to achieving a particular outcome”*.

However, there were reservations about whether the intentions had been or would be achieved in practice. A number of concerns about the new approach were expressed in the course of our interviews.

- One small practitioner indicated that there was sometimes a potential tension between the different high-level principles, such as between the need to run the business effectively and the need to be a good lawyer. Thus, undue regulatory attention on matters of business planning, finance and governance could draw the scarce resources of small firms, including ‘management attention’, away from the primary goal of serving their clients/customers.
- Another interviewee noted that the SRA didn't really have a handle on the issue of business risk, and this was because they did not have an incentive to get it right. She suggested that the firms themselves were in a much better position to assess business and financial risks for the simple reason that they had strong incentives to do so.
- Related to the above point was a criticism that SRA seem to be operating in a world that is disconnected with the real world profession. One interviewee lamented that if only SRA

would “road test” some of their suggested approaches or procedures on practising lawyers before rolling them out they would reduce inefficiencies and also earn greater respect.

- Another interviewee observed that, in her view, the SRA “turns every question back on you”, and this was not terribly helpful as it left a question mark about “whether or not you have made the right decision”. In the words of the interviewee, the regulatory approach is one of “*asking lawyers to look at a woolly outcome, when we are used to thinking in terms of procedures and rules*”.
- One interviewee from a two partner firm went as far as saying that sometimes SRA appears to be reverting to rule-based approaches which undermines outcomes-focused risk management.

Law firms first encounter these types of issues when they initially seek to enter the market, and the potential costs are probably greatest at this point for at least two reasons. First, and as already mentioned, new entry involves considerable ‘co-ordination’ problems in that a set of economic resources (finance, insurance, personnel, authorisation, premises, etc.) have to be brought together in circumstances where the availability of one resource can be contingent on the availability of others. Failure to achieve efficient co-ordination can be expected to lead to higher initial debt and/or to abandonment of plans.

Second, uncertainties about prospects are likely to be particularly high at the time of market entry, giving scope for reasonable people to arrive at different views. In market economies the ultimate decisions are generally left to those who put their own capital at risk. In the case of risk-based authorisation, the SRA can veto an entry decision if it judges the business prospects to be too risky in some sense or other. This is the burden of the point made by the second interviewee in the above list, and the only thing to add is that the issue is perhaps at its most acute at the moment of entry.

It was acknowledged in one of our interviews with SRA staff that, as a general matter, “*small firms don’t like this regulatory approach*”, and that there was a problem of a lack of trust in the industry. Specifically, some law firms are wary of the SRA and are concerned, in particular, that the SRA will not act proportionately in assessing whether or not they are complying with regulations.

An implication of this uncertainty is that it may make firms more cautious and conservative. In this way, it may discourage firms from organising their activities in innovative ways on the basis that they are not sure whether new approaches will be compliant with the risk-based outcomes focussed approach, and therefore whether authorisation will be granted. Given the general co-ordination problems that new entrants have to solve, there appears to be a regulatory bias toward ‘safety first’ approaches; and the bias can be expected to be more pronounced for those seeking to try out different (non-traditional) business models.

Similar phenomena are observable in other sectors of the economy as other studies by the Regulatory Policy Institute have confirmed. One strategy that is reasonably common for small firms in dealing with regulation is to “stay below the radar”, which means that firms consciously seek to avoid developments that will trigger a regulator’s interest in their businesses. In some sectors where there are precise quantitative criteria for determining when particular regulations apply, usually on a size basis, firms may choose to restrict investment and stay small. In legal

services where triggering events are less precisely defined, staying below the radar more likely means avoiding doing anything unusual, such as would attract the attention of the SRA.

Moving from the level of the individual practice to the market as a whole, an overly restrictive approach to authorisation risks stifling or impeding experimentation and innovation that would be to the benefit of consumers in aggregate. There is clearly a trade-off here in that individual business failures (experiments that did not work) risk causing harm to small groups of consumers (those served by the failing firms). However, whilst we found general recognition of the immediate and direct effects of a business failure on sub-sets of consumers – a recognition that has called forth or contributed to the strengthening of a number of consumer protection measures, such as mandatory professional indemnity insurance, the intervention process, the solicitors' compensation fund, and the ombudsman process – there appeared to be much less awareness in the sector of the potential harm that can be caused to consumers by any dampening of the process of experimentation, discovery and innovation (often associated with new entry) by which most economic progress is made.⁴¹

At the current stage of implementation, the SRA documentation appears to be falling between two stools of 'outcomes-based' regulation and 'rules based regulation'. For example, the SRA Handbook, described in more detail below, sets out a number of detailed rules and requirements that authorised entities need to meet. The Handbook also includes the desired outcomes, and the SRA emphasises that it wants regulated firms to identify how best to deliver these outcomes. There is a potential risk that, when there is a potential choice, the detailed rules and guidance will remain the chief focus of firms, and that firms will not explore different ways of promoting the desired outcomes. The risk stems in part from the fact that it is easier to comply with prescriptive rules, not least because it is easier to know what compliance means/requires when such rules exist, than it is to work out how to comply with requirements that are specified in terms of generalised outcomes, and that will be judged on the basis of how the SRA sees things, not on how the firm or its customers might see things.

Similarly, the SRA sets out indicative behaviours that could be expected to deliver the outcomes. Whilst these are non-mandatory there is a sense throughout The Handbook that if a firm chooses another, different approach to meeting the outcome they would have to provide a detailed justification for this. In this world, particularly for smaller firms that may already struggle to understand and meet all requirements, one would expect a tendency to stick with the 'suggestions' of the SRA than to really consider innovative options. While it may be too early to tell what the eventual impact of the relevant guidance will be, the implication or impression that any departure from the indicative behaviours needed to be justified was a theme that ran through a number of our interviews.

Closely related to this point, the precise definition and standing of guidelines in the Handbook is generally unclear. For example, in the Accounting Rules guidelines are provided on accounting procedures and systems to ensure compliance with the requirements. The suggestion is that firms

⁴¹ This is an example of a general cognitive bias that tends to be observed in circumstances where, if things go wrong, the effects are highly visible, whereas, if beneficial opportunities are missed, the foregone benefits are not easily observable. We found no clear recognition or discussion of the issue in the regulatory documentation that we examined.

can adopt their own approach to compliance but this is caveated by a claim that if there is a problem, any deviation from the guidelines will need to be justified. Again, it might be expected that firms will go with the ‘focal point’ guidelines in preference to developing different approaches, which would expose them to greater regulatory risk.

5.2.1. Entry into and progression through the profession

Issues surrounding entry into the profession are relevant to questions about barriers to entry going forward, since today’s trainees are tomorrow’s potential entrants. Discussion of professional entry also provides the most natural way of introducing a piece of economic analysis that is highly relevant to the more general question of the impact of regulation on practices’ costs, including costs of entry, exit and business restructuring.

It is a widely documented fact that fewer training contracts are currently being offered than in the relatively recent past. The Law Society’s annual statistics report for 2012 revealed that the number of training contracts registered in the 12-month period to July 2012 dropped to 4,869, down 10.5% from the previous year’s equivalent total of 5,441.²¹ The Law Society has also highlighted a substantial reduction in new admissions to the solicitors’ profession, which fell by a quarter (24%) in 2011-12 to 6,330 from 8,402 the previous year.²²

Among those firms interviewed who said they did not offer training contracts, the main (but not the only) reason cited was the regulatory burden they faced. The firms that offered views on this issue were all small firms with fewer than four partners. They believed that, at least within their own practice areas, they could offer trainees a valuable experience but that the procedure and management required by SRA regulation was prohibitive. They felt that they were not alone in their views and that potential trainees were being deprived of opportunities because smaller firms could not justify the extra regulatory burden involved. One partner said that he would consider offering training contracts if the regulation were reduced or if aspects of management of the training contract could be outsourced to a third party. Interestingly, the same respondent said that he would not outsource the COLP/ COFA functions in general, but would do so in the case of trainee management.

These types of views were most forcefully put by a partner in a four-partner firm: “[q]uite simply, for a small firm the regulatory burden is too high. We do not have the resources to deal with the extra regulatory requirements. This is a regret. I see many good candidates for training contracts but we do not feel that we could offer a place consistent with the existing regulatory obligations. Yet we do high profile and quality work and could offer trainees a good training experience.”

Of those interviewees who offered training contracts most regretted that they could not offer more, although this was said to be mostly due to resource/capacity and the firm’s desire to offer trainees a valuable experience during training, rather than to regulation. The constraints arose largely as a result of firms’ throughput of work, although we note that regulation is likely implicated to the

²¹ The figures are now at their lowest since training contract details were first recorded in 1998-99, when 4,827 were reported. The Law Society (2013), *Trends in the solicitors’ profession, Annual Statistics Report 2012*, May, <http://www.lawsociety.org.uk/representation/research-trends/annual-statistical-reports/>

²²The Law Society (2013), *Trends in the solicitors’ profession, Annual Statistics Report 2012*, May, <http://www.lawsociety.org.uk/representation/research-trends/annual-statistical-reports/>

extent that, as suggested by some, it absorbs significant resources that, in small firms, are not easily replaced by hiring in relevant skills. In general, small firms suffer from resource ‘indivisibility’ problems, which create management constraints of a type that can limit their growth, including by constraining their ability to train and absorb new skilled resources – a problem analysed by Professor Edith Penrose in a mini-classic of economics, *The Theory of the Growth of the Firm*.

Technically, management/professional capacity is a ‘quasi-fixed’ resource, meaning that it is fixed in the short term but can be expanded in the long term at a cost: the cost of training and integrating new personnel. This is less a monetary cost, more a cost that arises from the diversion of existing management/professional capacity from other activities, such as serving customers and running the business efficiently.

Regulation fits into this picture because it is another activity that places calls upon the limited managerial/professional capacity of small firms. The outcomes-focused approach to regulation can be particularly burdensome in this respect, because it places a greater burden on managers/professionals in working out what compliance means than do more prescriptive approaches (where compliance tasks are more easily routinised) or deregulatory approaches (which seek to reduce overall burdens). In the end, serving the client, running the business, regulatory compliance, and training all compete for the attention of a highly limited resource.

As stated, reductions in the number of trainees can be expected to affect entry via their effects on the number of practitioners likely to be interested in setting up new practices in the future. Since traineeships are not the only entry route, we would expect the effects to be mitigated in part by access to alternatives; albeit only in part since the alternatives are unlikely to be perfect substitutes, and hence some future members are likely to be lost to the profession as a result. The costs of training also have potential effects on barriers to mobility, providing another example of the entanglement of the various types of barrier. We will return to this point in the next section.

5.3. Other studies on potential barriers to entry

It is beyond the scope of this research to undertake comprehensive analysis of barriers to entry in the market: our interest is confined to the potential contribution of regulation to the relevant costs. However, we summarise here findings from studies carried out by others to the extent that they relate to the focus of our analysis.

OFT (2001)²³ found that professional (not entity) entry requirements relating to competency were not a problem and were appropriate given that consumers are not well placed to assess quality of service. The study also found that entry restrictions relating to education and experience qualifications were justified on the grounds of *ex ante* quality control, but recognised that they could deter entry to a profession. At the time the OFT was most concerned about restrictions on the creation of multi-disciplinary practices (a regulatory restriction of types of entities) and many of these concerns have been dealt with through the Legal Services Act 2007. However, the general points that restrictions on demarcation of services or on ownership, management and control of firms can create barriers to entry may remain valid in more subtle and indirect ways.

²³Office of Fair Trading (2001), *Competition in Professions*, March, http://www.offt.gov.uk/shared_offt/reports/professional_bodies/oft328.pdf

Europe Economics (2013)²⁴ noted that, in general, regulation in the legal services sector was complex. They also suggested that the potential for duplication of regulations for ABSs, regulated by multiple regulators, may be an issue, but recognised that it had not been identified as a major burden in their interviews. That theme, however, was reflected in our interviews with one accounting firm commenting that: *“For us, and probably most other MDPs, the biggest issue is that of double regulation – across the business. This may be less of an issue with non-professional services firms such as retailers entering the legal services market. However, we are already a regulated business and there need to be good reasons for subjecting the business to more regulation, in very similar but sometimes very different areas. We are already well risk-managed and that provides a culture of compliance that underpins all areas of the business”*.

Europe Economics also found the application process for authorisation of ABSs was lengthy and time consuming, although they noted that this could be because the licensing arrangements are relatively new. They estimated that it cost between £27,000 and £160,000 more to be licensed as an ABS than as a traditional legal firm. The conclusion of the study on ABSs was that there was no direct barrier to entry from the licensing regime, but the cost and time involved with the process could potentially be a deterrent.

In its review of competition in professional services (2004) the European Commission emphasised that regulatory rules *“must be objectively necessary to attain a clearly articulated and legitimate public interest objective and they must be the mechanism least restrictive of competition to achieve that objective”*.²⁵ The Commission particularly noted the case for reviewing regulation relating to reserved task lists, encouraging regulators to find other ways to ensure quality (e.g. through independent accreditation). In addition, the Commission (2004) suggested that business structure restrictions should be avoided if there are alternative means to protect independence and ethical standards. In its follow-up 2005 report²⁶ the European Commission suggested that assessment of regulations would be improved if there was a clear understanding of what was meant by the public interest. The Commission also emphasised that protections that relate to individual consumers and one-off users are more likely to be warranted, and that business and public sector users of professional services may have limited needs for regulatory protection. At present, there is no distinction in SRA regulations on the grounds of who the client or affected party is, suggesting that, if the European Commission’s view is correct (which we think it is), it follows almost directly that there must be disproportionality in some aspects of the current arrangements in England and Wales.

5.4. Interim conclusion on entry

Based on our assessment of the authorisation requirements and assessment process, taken together with other studies on barriers to entry in legal services market, we do not consider that there are *major* impediments to the entry of new firms based on traditional solicitor models in which the

²⁴ Europe Economics (2013), *Economic Research into Regulatory Restrictions in the Legal Profession: A report prepared for the Office of Fair Trading*, January, http://www.offt.gov.uk/shared_offt/reports/professional_bodies/OFT1460.pdf

²⁵ European Commission (2004), *Report on competition in professional services*, February, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2004:0083:FIN:EN:PDF>

²⁶ European Commission (2005), *Professional services - scope for more reform*, September, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2005:0405:FIN:EN:PDF>

leading roles are filled by those with practising certificates. There is also little in the rules to create *major* barriers for sole practitioners, provided that that the SRA applies the rules in a proportionate way for small firms. The requirements are broadly in line with other types of professional firm providing services that customers find difficult to evaluate in terms of quality, and where firms handle confidential client information.²⁷ More significantly, evidence to the effect that new entry rates are not particularly low in comparison with other sectors is consistent with this conclusion.

There are, however, one or two impacts on barriers to entry that, whilst they are moderate in scale, are nevertheless potentially significant when account is taken of the pivotal role that new entry can play in injecting innovation and dynamism into a market. One such is the potential for regulatory requirements to be disproportionately onerous/costly for new or innovative business models, including but not restricted to ABSs. Specifically, these organisations may find it more difficult to provide convincing evidence that they can manage the risks highlighted by the SRA. This would be particularly the case if a firm had a new ‘untested’ business model or if staff have non-standard backgrounds. The question is whether these alternative business structures present a higher risk to consumers or wider public interest that would make the higher burden proportionate, taking account also of the risks of harm that are involved in preventing the development of innovations that would improve consumer welfare, both directly and by intensifying competition in the market.

Another issue is the sheer volume of information that has to be absorbed by new entrants if they are to understand regulatory requirements and hence understand the risks to which they might be exposed. This is a barrier to entry in its own right, and its proportionate effect on unit costs is higher the smaller is the firm.

²⁷ For example, dentists also have qualification and CPD requirements similar to those required by the SRA. They must also apply to be registered and pay a fee to the regulator, the General Dental Council on an annual basis.

6. MOBILITY

6.1. Introduction

A firm providing legal services may want to change its business structure for a number of reasons. These include making cost savings, for example by seeking economies of scale or economies of scope, increasing revenue by obtaining access to a larger client base, improving marketing resources, better managing risks, and seeking either more focus or greater diversification in services provided. Such changes in strategies – which can be referred to as strategic ‘mobility’ – are typically responses to changing economic circumstances and, as such, they are partly reflective of competitive conditions. Businesses that are not under competitive pressure have the discretion to decide whether or not to be strategically ‘mobile’ in the face of change: they may make better or worse financial returns depending on their decisions, but those decisions are not likely to be existential in nature. In contrast, when competitive pressures are strong, the ability to adapt and change business strategies and structures may be necessary for survival.

Mobility, as defined, is generally good for consumers. A market in which there are strong impediments/barriers to mobility, or in which there is little mobility because the pressures to adapt old ways of doing things to new circumstances are weak, will be less responsive to changes in demand conditions. That means that, in aggregate at least, suppliers will be less responsive to consumer requirements. Ensuring that legal services regulation is not conducted in such a way as to create significant, avoidable barriers to mobility is therefore a natural ‘intermediate objective’ for regulators who are guided by the higher-level objectives of the LSA.

Whilst there are many different types of business structure changes that might be contemplated by solicitors’ practices, for the purposes of the study we focused on a more limited number of possibilities, chosen for their likely empirical significance. They are:

- a firm changing its business form from sole proprietorship to a traditional firm (e.g. company, partnership or LLP);
- a traditional firm wanting to merge with another firm (or potentially a takeover of one by the other);
- a traditional solicitors’ firm merging with firms with other business interests to provide Multi-Disciplinary Services;
- a law firm partner or associate seeking to establish a new practice as a sole practitioner.

In section 3 above, evidence on the relative numbers of practices with different legal forms (sole proprietorships, partnerships, LLPs, limited companies) indicated that there have been major changes in the market over very recent years. This, however, does not imply that it is straightforward to change from one type of structure to another. For example, the large increase in the number of limited companies could have been driven chiefly by the popularity of this type of structure for practices being set up for the first time (the numbers of new openings being well in excess of the increase in the number of limited companies). Indeed, information gained from interviewees suggests that it is not necessarily straightforward for an existing practice to switch to

a limited company structure, supporting the view that the market-level change might have come chiefly from new entry not from intra-market mobility.

On the other hand, the fall in numbers of partnerships and sole proprietorships, which far outstrips the number of closures, does indicate that there has been considerable merger or take-over activity in the market, and this was confirmed in interviews. Thus, just as there has been a high rate of merger activity among the largest legal firms over the past two or three years, so there have been high levels of such activity among smaller practices. It is therefore possible to be confident that, even if regulatory requirements surrounding amalgamations are, as many suggest, disproportionately high, they are not so high as to prevent overall market adjustment at what, in this case, can reasonably be described as a relatively brisk pace.

As in the case of entry, however, aggregate statistics may not capture some of the more specific issues surrounding barriers to entry. In relation to mobility, it might also be the case that it is the more innovative adjustments in business models, structures and strategies that are most affected by regulation, and there is an additional, related issue of *barriers to expansion*. In general, it may be small comfort to a business if circumstances are such that it is relatively straightforward to enter a market but next to impossible to grow/expand within the market.

Barriers to expansion are a sub-set of barriers to mobility, and therefore highly relevant for our assessment. For example, the first of the four types of firm restructuring listed above – a transition from a sole proprietorship to a partnership of some kind or other – will typically be closely associated with an expansion in scale.

Given these preliminary points, in this section we describe particular aspects of the SRA Handbook and associated Notice of Succession⁴² requirements that apply specifically in the event of a change in business structure. We also present our analysis, primarily based on interview and survey feedback, of the extent to which regulations relating to business structure changes are a potential barrier to mobility in the market.

In the exemplar cases listed above, the changes in business structure would typically require the new firm to apply for a new authorisation with the SRA. The earlier analysis of authorisation in the context of entry is therefore relevant here, as the ability to change business structure ultimately depends on how easy it is to obtain a new authorisation. However, we note at the outset that authorisation in cases involving changes in business structure appears to be regarded by solicitors as giving rise to more problems than authorisation of completely new entrants. This is likely due to the fact that such entry barriers as exist are greatest for non-traditional business structures, which are currently small in number, whereas costs associated with amalgamations fall equally, or more than equally, on traditional business structures. Thus, following its 2010 consultation on successor practice definition, the SRA reported that the great majority of respondents believed that the existing rules gave rise to difficulties, and that the Law Society had argued that “*the current definition [of a successor practice] acts as a barrier to mergers and acquisitions which is detrimental to firms and clients.*”

⁴² Solicitors Regulation Authority (2013), *Completing a notice of succession*, <http://www.sra.org.uk/ns1/>

6.2. SRA Handbook and business structure changes

Table 5 below highlights some (but not all) aspects of the SRA Handbook that refer to changes in business structure.

Prima facie these requirements do not appear particularly burdensome, with the possible exception of the requirement for approval of managers, owners and compliance officers, whose impact will depend to a large extent on the SRA's enforcement policies. Thus, one of the principal reasons for regulatory concern with changes in business structure, to provide information required to calculate SRA fees, seems innocuous to us. The SRA website itself says that:

“In many cases, applications are relatively straightforward; they may involve partners from existing firms who have split away from or merged with another firm, all of whom have a clean track record, with a strong business plan and evidence of appropriate systems and controls. In these cases, there is limited risk to the public.”

However, this initial impression has to be reconciled with experiences recounted in interviews.

For example, a high-street practitioner explained that she had not had difficulties in opening a sole practice. However, things were much less straightforward when she decided to change to a limited company structure. The process took a long time, and involved a lot of working out of what information was needed. There was a large number of questions to be answered, and she found the process to be disproportionate, particularly given her previous track record as a sole practitioner.

Similarly a partner-firm in a specialist area (dispute resolution) told us the following:

“... we decided to set up a silent company to deal with the scenario if one of the two partners died. This was part of a risk mitigation exercise. I filled in the original ‘current’ form only to be sent another new 95 page form which had superseded it. I filled that in. I was then presented with yet another form when I found out I could apply for a waiver from certain formalities. Much of the compliance information replicated what we had provided for the main active business – yet in some respects it was not good enough to SRA! They needed to take a step back and see that we were trying to manage risk. Barriers were presented along the way and there was no effort to streamline the process.”

These views are supported by responses to our supplementary survey questions, which highlighted regulatory constraints as a significant factor in amalgamations of law firms. Of those firms that had been involved in an amalgamation of some kind: 16% said they encountered major regulatory issues, 52% said that the regulatory problems were significant, and 28% said the regulatory issues were straightforward.

Table 5: Assessment of rules affecting mobility

Section of handbook	Regulations relating to mobility	Rationale	Assessment
Accounts Rules 2011	The requirement to provide annual audited accounts remains if a partnership splits or a sole practitioner retires if the old entity continues to hold client money. Once a firm stops receiving client money, a final report needs to be provided.	Protect client money and legal services reputation	There will be a cost to providing final accounts. This expense is not expected to be significant and in itself is unlikely to be a barrier to mobility or exit.
SRA Authorisation Rules for Legal Services Bodies and Licensable Bodies 2011	Notice of succession needs to be provided to SRA, including details of turnover that will be used as basis for calculating SRA fees	Ensure SRA information up-to-date when calculating SRA fees based on turnover	May involve some complex calculations, but firms might reasonably be expected to be able to provide the required information.
SRA Authorisation Rules for Legal Services Bodies and Licensable Bodies 2011	Changes to partnership to be notified to SRA within seven days	Ensure SRA has up-to-date information and ensure authorisation remains valid	Does not appear to create any significant regulatory burden if the partnership changes do not require a new authorisation.
SRA Authorisation Rules for Legal Services Bodies and Licensable Bodies 2011	SRA needs to approve authorised body's managers, owners and compliance officers	Ensure authorised body has staff with sufficient skills/qualities to meet wider SRA requirements.	May create delay which could be very costly in what might sometimes be difficult circumstances. May prevent or inhibit transactions.
SRA Practising Regulations 2011	Under regulation 5 a firm needs to give notice of succession if there is a merger or firm split.	Allows SRA to apportion historic turnover to determine the size of the SRA fee for the remaining authorised body.	Appears to duplicate elements of Authorisation Rules but otherwise not significant regulatory burden.

The likely resolution between the implied simplicity of written-down requirements and the experiences of law firms lies in the detail of the enforcement of the regulations. There is an obvious point to make here about the benefits of regulatory agencies avoiding box-ticking approaches to enforcement and to look at the substance of matters, just as regulators themselves urge businesses to do when stressing the virtues of outcomes-focused regulation. This is the point made by the second of our two interviewees when he said that *“They needed to take a step back and see ...”*

We see three difficulties at this point however, the identification of which builds on earlier remarks on entry barriers in section 5. First, it is not clear that it is realistic to expect that the SRA has the capacity, or will ever be able to develop the capacity, to see the substance of things. Each (of many) business adaptation(s) will have its own unique features, and the difficulties in understanding what is going on can be expected to increase the more innovative the adjustments. Significant reliance on box-ticking may therefore be reasonable in the circumstances, and the problem seems to lie in the disproportionality of the exercise: in the above examples the relevant people were lawyers with practising certificates, with track records in authorised firms. We might expect, therefore, that authorisation for the new entity should be semi-automatic, with further questions and delays only triggered in the event of clear warning signs; and this view is reinforced by the fact that, restructuring options may be time sensitive for those involved (i.e. significant delay may force abortion of the plans/project).

Second, we have earlier discussed the tendency of regulatory agencies toward asymmetric and risk-averse approaches that are heavily focused on the costs (to the regulator) if things go wrong, and that largely ignore the costs of preventing or impeding developments that will have positive benefits (because they are ‘unseen’). An amalgamation is a ‘triggering event’ that is liable to catch the eye of the regulator, because, under the regulations as they stand, it is seen as a potential risk to the regulator’s reputation and interests. Perhaps the biggest risk (to LSA objectives) is that, anticipating that it will be trigger event, and wishing to ‘stay below the radar’ to reduce the risk of disproportionate action, firms will be deterred from restructuring in the first place; and that is the description of the effect of a barrier to mobility.

Third, and most fundamentally, we are left with the basic question of why a legal services regulator should want to supervise the management and financial structures of large numbers of businesses, many of them very small on standard economic metrics, particularly in situations where the parties in restructurings or amalgamations are established, authorised practices, and the lawyers involved have practising certificates whose loss would put their careers at risk. There is, to the best of our knowledge, no evidence base to suggest that such supervision has any beneficial effects for consumers; and, whilst it is always possible, by judicious choice of (frequently implicit) assumptions to make an argument why such beneficial effects *might* exist, there are some classic economic reasons why such supervision might have effects that are close to the opposite of those intended. As one high-street general practitioner put it in relation to supervision that creates complexity: *“For a smaller practice it puts a strain on our senior management who have to sacrifice a large amount of potentially billable time That has to be done by a senior partner, further distracting that person from clients and staff.”* The last point here is another example of the ‘Penrose effect’ (See section 5.2 above).

6.3. Notification and approval requirements in mergers

The SRA requires any firm affected by a change, such as a merger, acquisition or split, to complete a Notice of Succession.⁴³ The Notice must be made within 28 days of the change taking place and there is no fee. The Notice needs to be completed in cases where no new authorisation is required and in those where a separate new application, for example to be authorised in a different structure, is being submitted to the SRA. Any firm closing as a result of the change must also submit notification of closure separately. Precise details on the form vary slightly in each case.

The purpose of the Notice of Succession is to inform the SRA of the turnover of the new firm for the purposes of calculating periodic fees. The turnover of the affected firm should be based on an apportionment of the historic turnover of the firms involved. Where the parties involved cannot agree on the apportionment, the SRA will determine the appropriate figure using information provided previously and may charge a fee to do this (£250).

The Notice itself is therefore unlikely to be a barrier to changing structure, although the difficulty in parties involved agreeing the turnover figure may be. If succession results in a change of business activities or organisational structure then new authorisations may be required. The assessment of these is set out above in section 5 in the context of barriers to entry. There are also professional indemnity insurance implications to becoming a successor firm that may discourage some from taking on this role. The implications of insurance are discussed in Section 6.4.3 below.

The bigger problems, however, appear to be less to do with the specific regulatory requirements that are specifically linked to merger, and more to do with the general implications of the current approach to regulation for the conduct of participants in mergers and other types of restructuring. Consistent with the outcomes-focused philosophy, solicitors will need to consider what compliance means in the new circumstances, and whether they will be able to demonstrate compliance to the SRA; and to do this they will, in effect, have to look through the whole of the 'rule book', from high level principles through interpretations of the implications of those principles, through mandatory outcomes to detailed prescriptive rules. This is a potentially major task.

There are also more specific notification and approval requirements (in addition to the Notice of Succession) to take into account. Recognised bodies are required not only to notify, but also to receive prior approval for, new managers and owners who may be joining as part of a restructuring. As indicated above, this may be straightforward if the relevant managers are solicitors with a current practising certificate, but approval is required nevertheless, and approval takes time. Similarly, if restructuring involves a new COLP and/or COFA, approvals will again be required. More generally, restructuring firms will need to go systematically through the SRA Handbook to search for notifications and approvals that may be required in the new circumstances.

⁴³ Solicitors Regulation Authority (2013), *Completing a notice of succession*, <http://www.sra.org.uk/ns/>

6.4. Assessment of effectiveness of mobility rules

6.4.1. Trends in mobility

From our interviews, it appears that there is currently considerable interest in firms adjusting their structures and strategies, including in amalgamating or merging their activities. Indeed, all the people we have spoken to suggest that there is a fairly active market for mergers/buy-outs/amalgamations, and that there exist a number of ‘matching’ firms that seek to bring together buyers and sellers of law firms and practices. However, one respondent from a small high-street firm noted that the market can be cyclical, and while she said she is currently receiving ‘masses of approaches’, there were years when she did not receive an approach at all.

In *Risk Outlook 2013*⁴⁴ the SRA noted that there is “a growing trend of mergers” and, with growth of large firms, an expectation of more consolidation in the sector, and that “a small-scale survey indicated that 76% of law firms have considered the possibility of a merger over a six-month period and 20% of firms with more than 10 partners completed a merger in 2012, compared to 14% of smaller firms”. The 14% figure here is strikingly similar to the tentative inferences we have made from the aggregate data in section 3.3, where we suggested an exit rate attributable to amalgamation of up to about 7% per annum. Remembering that amalgamations typically involve two firms, this would translate into an upper bound estimate of 14% of practices being involved in amalgamations. Care must be taken, however, not to read too much into this convergence of estimates, which may be no more than coincidence. For example, the cited survey covered only 65 firms and the number amalgamations recorded appears to have been eleven.

Much of the smaller scale merger activity has been in the conveyancing market, reflecting the poor economic conditions and low demand in this area. The *Risk Outlook 2013* notes that conveyancing is showing the highest rate of consolidation, with the largest ten conveyancers handling 28% more of the total property transactions in 2012 than was the case in 2010. Our interviews provided examples of smaller scale bolt-on acquisitions in specific practice areas (e.g. crime).

6.4.2. Suitable buyers

The survey cited by the SRA suggested that the great majority of practices that contemplated a merger in 2012 did not actually carry those thoughts through into decisive actions. It is safe to infer, therefore, that there were considerations that counted against the transactions. Some of these may have been of a regulatory nature whilst others would likely have been more directly commercial factors.

In considering the significance of potential regulatory barriers to merger/amalgamation, it is useful to compare what was said by interviewees about the impact of regulation with what they said about other obstacles to such transactions, since the latter provides a benchmark for assessing the former.

⁴⁴ Solicitors Regulation Authority (2013), *Risk Outlook 2013: The SRA's assessment of key risks to the regulatory objectives*, July, <http://www.sra.org.uk/solicitors/freedom-in-practice/ofr/risk/risk-outlook.page>

Given that successful mergers/amalgamations can require significant levels of business skills, it is also useful to look at what both solicitors and non-solicitors say about solicitors' business skills.

In some cases, we were told that an opportunity or offer was not pursued because it was inconsistent with a firm's own future plans for their business (i.e.: a desire not to be part of a bigger organisation). In other cases the decisions reflected something unsatisfactory about the financial offer being made.

An obvious factor that might have been at work in cases where practices were approached with an offer to merge/amalgamate is the adverse selection problem. As one interviewee put it, in explaining why he was suspicious of firms making such approaches, mergers are a way for practices to "*cover up their losses*" by getting other people to buy into their debts.

Adverse selection is clearly a more general issue, extending into areas such as insurance (see below). The question is always: why does the other firm appear to be keen to merge or be taken over? The fear that the other party in a transaction is hiding future potential liabilities tends to be a powerful factor in limiting merger/amalgamation/take-over activity, at least when decision makers have substantial amounts of their own money at stake (the economic evidence on acquisitions of large quoted companies, where senior executives are betting with other people's money, suggests that things are different in that world).

Adverse selection implies that proprietors seeking to sell well-run practices may have difficulty in achieving an offer that fully reflects the value of the practice, the offer price being discounted to account for the buyer's perceptions of risks that not all is well; and this would be one, good reason why proprietors may, in the event, choose not to sell. We heard from more than one interviewee that offers to buy had been made but the offer was considered inadequate.

One interviewee attributed such refusals to a lack of commercial skills on the part of many solicitors, and hence to a tendency toward over-inflated views of what their businesses were worth. It is difficult for us to comment on the latter part of this statement – we are not experts in practice valuation – but the first part has some basis in economics in the sense that, the lower the level of commercial skills, the greater is likely to be the adverse selection problem (because lower levels of commercial skills tend to increase exposures to becoming encumbered with bad risks by the counterparty in any transaction).

Whatever the cause, the survey results indicate that when asked the question "*If you were approached with an offer to buy your legal practice, which of the following do you anticipate would be the biggest obstacle to the proposed acquisition?*", of those who had a clear opinion 56% of indicated the likelihood of an inadequate purchase price; 24% indicated a strong preference not to sell; 11% indicated regulatory difficulties; and 7% indicated insurance difficulties

Another commercial factor of significance when firms are amalgamating is the extent to which the two businesses are good organisational matches for one another. Individual firms are bundles of resources and have 'ways of doing things' which can differ substantially from one another, and it is not necessarily straightforward to find combinations that work well. One interviewee operating in the new media sector emphasised the importance of cultural fit between the two firms. This was very difficult to test when firms were first introduced by an intermediary. He remarked that "*they*

did not really understand our structure. When I explained this, it was clear that we were far apart in our business models and in terms of our respective cultures.”

Similarly, a good fit with the existing management can be an important factor in private equity investments in ABSs. One private equity investor told us that *“we knew that management fit was fundamental and that an investment could only be attractive with a dynamic forward thinking partnership. We really like the company and the existing management”*.

Finally, mention should be made of the Transfer of Undertakings (Protection of Employment) Regulations, to which our attention was directed by a restructuring consultant. These are employment regulations that protect the positions of employees when the business they work for has been transferred to another business. In the current context, this means that a successor practice is required to take on obligations to employees of a firm that it is taking over, which inevitably tends to increase the economic cost of the transaction, possibly by a significant amount. These employment regulations do have a material upward effects on the costs of mobility, and hence on the costs of entry and exit as well.

Overall, it was clear to us that, even in the absence of any additional difficulties introduced by SRA regulatory requirements (e.g. successor practice rules in combination with insurance rules), these factors were highly significant in helping explain why most of those thinking about amalgamation/merger in a particular period do not, in the event, act on those thoughts.

6.4.3. Impact of insurance

A more general commercial issue identified as being relevant to barriers to strategic and structural mobility, and in particular to amalgamations, concerns the risks associated with assessing the potential claims that will be taken on in consequence of joining with other practices. The adverse selection aspect of this – which affect how practices themselves see the risks – has been discussed above, but the other matter to consider is how insurance companies will look at matters. Thus, just as enthusiasm for merger may signal to a potential partner a risk that not all is well, it may do so for insurance companies also. Insurance rates may therefore rise as a result.

Another insurance-related issue is whether a record of frequent changes in business structure may make a practice less attractive to insurers. In interviews we found no clear indication that this was the case, and insurers seemed relatively unconcerned about such a record, with the proviso that they always needed to ensure that they had sufficient information to satisfy themselves of the new risk profile of the relevant insured firm and its partners/owners.

In many respect a “track record” in a similar legal services or professional services firm should be helpful in securing insurance; although it is possible that the position may be different for an individual solicitor who, after successive attempts to find a secure position in a law firm, decides to move to set up his own sole practice or, after having done so, seeks to merge with another sole practitioner.

Indeed, one insurer commented on the potential risks presented by lawyers *“with a CV to resemble the A-Z of London”*. It is a fact however, that an increased frequency of such cases may be an inevitable consequence of current market developments. As one interviewee put it: *“[a]*

longstanding feature in one of the law magazines is a ‘departures’ and ‘arrivals’ lounge’. Insurers may, of necessity, have to become more expert at reading road maps.

6.4.4. **Mobility and solicitors’ culture**

At this point, we believe that it is useful to reflect on some of the prevailing themes concerning legal services culture that emerged from our interviews, since these are relevant to reconciling a number of views that have been expressed in interviews with the implications of our analysis of the SRA’s approach to regulation. Whilst these comments are relevant to all aspects of our study, they are particularly apposite here, where the issues are specifically to do with the obstacles or barriers to adaptation by those already established in the market.⁴⁵ Thus:

- The legal services sector has been described by interviewees as “traditional”, “conservative” and “slow to change”. While we have identified many examples of innovation in the sector, we see no incompatibility between this and the description just given. There are very many solicitors’ practices, many of which fit the ‘traditional’ description, and an increasing number of which don’t. Annex 6 briefly summarises some of the ‘alternative strategies’ that we encountered.
- Similar remarks can be applied to the view, expressed by both non-solicitor and solicitor interviewees, that many practitioners are not good at the commercial side of things. As a general rule, people tend to become good at things that are necessary for their survival and prosperity, and in past periods commercial acumen may have been less important than it is has since become: it may have been sufficient in the past for a solicitor in a small practice to have been a good lawyer, whereas that may no longer be the case. As in relation to the ‘conservative’ characterisation, therefore, what the evidence suggests is the simultaneous existence of different cultures in the market, although we believe the magnitudes of the differences can easily be exaggerated.
- When considering the options for mobility as an individual, one interviewee noted that “*it is hard to move in certain directions such as:*
 - *in-house to private practice*
 - *small firm to city firm*
 - *city firm to sole practitioner*
 - *law to non-law*
 - *non-law to law late in life*”.

⁴⁵A theme of this study has been the relationship between barriers to entry, mobility and exit. The costs of entry and exit are at least theoretically related to the question of mobility or a change in business structure on a dynamic basis. Thus, the costs of entering into a new area of legal practice through merger or a change in operating format may be characterised just as easily as ‘entry’ or as ‘mobility’. Similarly, the decision to change business strategy or structure (mobility) may be affected by the ease of exit should the chosen change in approach not prove successful.

On the basis of this list, the barriers to (individual) mobility appear to correlate with cultural variations, although, of course, other factors, including regulation, no doubt also play a role.

- Sole practitioners seeking to merge their businesses will face challenges similar to those in many other professional businesses when recruiting at the senior level, namely a combination of business case and cultural fit. This was explained by one partner who said that “[w]hether it is a single partner or a team, we need to be convinced that they are a cultural fit as well as a sound financial proposition. A lot of time is invested in the process. You never really know if the new hire can integrate effectively and if the client base will move with them. It is a big risk on both sides (firm and new hire).”
- The recent and current economic situation may have contributed to greater risk aversion at the same time as it has obviously increased the pressures for change within the sector. One partner observed that “lawyers tend to prefer home grown talent unless there is a strong business case that the hire(s) will be accretive to revenues and not damage culture”.
- Generational and gender factors have a role to play in understanding mobility. We detected a marked difference in the views, perceptions and aspirations of younger participants. These views indicate a trend toward early-career decisions to remain flexible as to future options and toward a belief that loyalty to one firm or one way of practising law was a thing of the past. In consequence, different groups may have different reasons for being interested in barriers to mobility and in ensuring that they are not unnecessarily high. For long established practices, business restructuring may be seen primarily in terms of survival strategies – change may be necessary to continue doing what has traditionally been done, at least to a good approximation. For newer entities, the concern may be more to do with having options for future careers and for business development, and with keeping the costs of switching between such options as low as possible. Thus, ensuring that there are no undue barriers to such mobility, regulatory or otherwise, will be increasingly important if the next generation of lawyers is to see a viable future in the profession.

6.5. Interim conclusion on mobility

Our conclusions on the impact of regulation on barriers to mobility are broadly similar to those in relation to barriers to entry. The significant level of merger and business restructuring that is observable in the market place indicates that change and adaptation have not been throttled by high barriers to mobility. Moreover, such barriers as do exist appear to be more related to commercial factors than to regulation.

Nevertheless, there does appear to us to be some disproportionality in the current regulatory approach, with the result that barriers to mobility are higher than they could and should be. Although the elevation appears modest in magnitude, the economic significance of the effects may, once again, be significant, particularly in a period when, faced with a sequence of external shocks – mostly on the demand side, but also arising from technological change – adaptability and flexibility are at a premium.

Perhaps the most fundamental issue can be precisely identified. We have cited the SRA's statement concerning mergers that:

“In many cases, applications are relatively straightforward; they may involve partners from existing firms who have split away from or merged with another firm, all of whom have a clean track record, with a strong business plan and evidence of appropriate systems and controls. In these cases, there is limited risk to the public.”

The mischief is implied by the words “*all of whom have ... a strong business plan and evidence of appropriate systems and controls*”. The obvious questions to ask about this are: how, in a merger situation, can the SRA satisfy itself on this point without actually assessing the business plans, systems and controls of the new entity or entities? And, if the SRA does assess the relevant business plans, systems and controls, how can it be said that the applications are relatively straightforward?

As in the case of barriers to entry, perhaps the major concern is that risk-based regulation will, as it is currently applied, target those changes that are the most innovative and least standard. That is, whilst regulation might not stop change, it may impair precisely those changes that might be the most beneficial.

7. EXIT

7.1. Introduction

An authorised firm may want to exit the market for legal services for a number of reasons, including (but not limited to) the following:

- a sole proprietor may wish to retire, change profession or move to another jurisdiction;
- a sole practitioner may not have a suitable successor to carry on the business after retirement;
- the owners and/or manager of a firm may wish to shut down for personal reasons including illness (long-term incapacity) or death;
- the firm may be facing financial difficulties and therefore need to shut down for commercial reasons;
- the firm may not be able to obtain professional indemnity insurance and needs to close down;
- there may be a legal concern with the firm or its owners/ manager (e.g. a fraud case) that means authorisation is withdrawn by the SRA and they can no longer operate.

The Law Society note on closure emphasises that the last of these situations may be a particular problem for sole practitioners.⁴⁶ If the individual loses their practising certificate they cannot be recognised as an authorised sole practitioner.

Exit may involve the firm passing on its business to another firm (succession) or it may involve complete shutdown of the business (no succession). We consider both. We also discuss whether there are other related barriers to exit in the market.

Failure to comply with requirements relating to closure can result in disciplinary action, intervention by the SRA and/or a negative decision from the Legal Ombudsman where clients have received poor service. If SRA intervention is required, where feasible the costs of intervention are recouped from the closing firm. This should provide some disincentive to disorderly closure. However, when there is disorderly closure the entity may well not be in a position to pay such costs in any case.

7.2. Rules and procedures affecting exit

7.2.1. Regulations relating to firm closure

The SRA expects all firms to have an exit plan or strategy in place that enables it to be wound down or taken over in an orderly way should that be necessary. This should be feasible for retirement or similar known events but may be more difficult in the event of sudden and unexpected financial

⁴⁶ The Law Society (2012), *Closing down your practice: regulatory requirements*, <http://www.lawsociety.org.uk/advice/practice-notes/closing-down-your-practice/>

distress or death of a partner, for example. Both the SRA⁴⁷ and the Law Society⁴⁸ emphasise in their guidance on closure that bankruptcy and disciplinary action can be foreseen given the timescales involved and contingency arrangements should be put in place.

The SRA Handbook, and associated guidance, sets out what a firm is required to do if it wishes to close down. The overall focus is on ensuring that the firm closes down in “an orderly and transparent fashion”.⁴⁹ All regulatory authorities must be informed of the closure and the firm must not provide services to clients after it has shut down. The authorised entity is expected to comply with all the SRA principles, and all associated regulations, during the period where the firm is being wound down or sold on (succession).

Consistent across the approaches of the SRA and the Law Society, the rationale for avoiding disorderly closure appears principally to be to protect the interests of clients, most notably in relation to protection of client confidentiality. The SRA guidance on ‘*Closing down your practice*’⁵⁰ also confirms that disorderly closure has wider impacts including on the courts and on others involved in transactions to which the closing firm is party. Other law firms may be affected, particularly where there is need for intervention and the costs of intervention have to be met, in whole or in part, by those firms.

7.2.2. Client management requirements

Consistent with the SRA principles and regulations in The Handbook, a firm closing down must ensure that the client is protected at all times. Measures to be taken include:

- **Informing clients:** All current clients must be informed about the closure, with sufficient notice to enable them to instruct another firm. In the case of succession, all clients must be informed of change of ownership and be given opportunity to choose between using the new firm and instructing another firm. Clients should also be informed if the new firm is not regulated by the SRA. Former clients should also be informed if their papers are held or the lawyer is acting as executor or similar.
- **Client files:** Files must be transferred to the client’s new firm, but only with the client’s consent, or to the client where possible. All client files and documents not passed on to new lawyers or returned to clients must be securely stored (archived) and the SRA informed of the location of the files. In some cases files might be destroyed. Client confidentiality should be considered when deciding on storage and transfer arrangements.
- **Client monies:** Where possible, all client money should be transferred out of client accounts, by paying disbursements, billing for outstanding costs and returning funds to clients. SRA rules are in place for dealing with any remaining monies (e.g. for untraceable clients). Where money is retained annual accountant reports should be provided. Money cannot be transferred

⁴⁷ Solicitors Regulation Authority (2013), *Closing down your practice*, 10 May, <http://www.sra.org.uk/closingdown/>

⁴⁸ The Law Society (2012), *Closing down your practice: regulatory requirements*, <http://www.lawsociety.org.uk/advice/practice-notes/closing-down-your-practice/>

⁴⁹ Outcome 10.13.

⁵⁰ Solicitors Regulation Authority (2013), *Closing down your practice*, 10 May, <http://www.sra.org.uk/closingdown/>

to a new law firm without the client's consent. In the case of succession, the new firm must set up new client accounts that are distinguishable from previous ones. Steps should be taken at all times to protect clients' interests during the transfer, in particular to protect against fraud.

- **Undertakings:** The closing firm should discharge any undertakings where possible or transfer responsibility to another firm. The liability remains with the sole practitioner or firm manager unless released by the recipient.
- **Financial records:** A final accountant's report must be provided within six months of ceasing to hold client monies. Financial records (e.g. accounts, other requirements under SRA rules, VAT records) should be kept for six years.

7.2.3. Informing the SRA and other parties

A firm planning on closing must inform the SRA of the intent to cease practising (before closure). The firm should provide the SRA with details of planned closure date and information on where client files and documents are stored. If the person closing down the firm is moving to a new practice, the SRA must be given details of the new firm.

In the case of succession, the firm taking over the closing firm must also inform the SRA of the change and may need to apply for a new authorisation depending on the impact on its business structure.

Other parties affected by the closure or succession must also be informed. This includes, for example, the firm's bank, accountants, and other creditors. A checklist is provided by the SRA.

7.2.4. Indemnity insurance requirements

7.2.4.1. A firm shutting-down with indemnity insurance policy

Under *SRA Indemnity Insurance Rules 2012*⁵¹, if the firm had indemnity insurance prior to closing, run-off cover⁵² is provided on the basis of the policy that existed at the time of closure for six years from the expiry of the policy. The insurer is obliged to provide this run-off cover. Insurance must be purchased from a 'qualifying insurer' that has a contract with the SRA. The SRA sets minimum levels of cover at:

- at least £3 million per claim for relevant recognised bodies and licensed bodies; and
- at least £2 million per claim for sole practitioners and partnerships.

A firm can choose to have top-up cover beyond these limits. The total amount required will depend on the firm's size and risk exposure.

The one-off payment for run-off cover (based on the SRA minimum terms and conditions) is linked to the firm's annual premium and is, according to the Law Society note on closure, "typically two

⁵¹ Solicitors Regulation Authority (2012), *SRA Indemnity Insurance Rules*, <http://www.sra.org.uk/solicitors/handbook/indemnityins/content.page>

⁵² Run-off insurance is a form of insurance which provides cover for claims arising after a firm or individual has ceased trading.

to three times a firm's annual premium".⁵³ The closed firm is also responsible for any excess in the event of a claim.

7.2.4.2. A firm shutting-down with no indemnity insurance policy

Firms that could not obtain insurance in the market used to be able to obtain insurance through the Assigned Risk Pool (ARP), at higher than normal premiums. The pool ceased to exist on 1st October 2013 and was not available to firms seeking cover from 1st October 2012 (except those already in it). Since then the last insurer of record retains the risk for 90 day extended policy period (EPP) provided by that last insurer. This means that if a firm does not renew its insurance, its last participating (qualifying) insurer will have to provide three month's (90 days) coverage. The EPP comprises a 30 day extended indemnity period (EIP) and a 60 day cessation period (CP). During the CP the firm can only deal with existing instructions. After the EPP, the firm will have to close if it cannot get a new policy.

7.2.4.3. Succession and indemnity insurance

If there is a successor practice, the new practice's insurer deals with claims made after closure, unless the closing firm made provision for separate run-off cover. If the closing firm chooses to rely on its own run-off insurance the run-off premium must be paid before closure. Arrangements for excess payments are included in the contractual arrangements between the closing firm and the successor firm.

The SRA noted in its 2009 consultation *'Solicitor Indemnity Insurance Rules Successor practice definition'*⁵⁴ that there is anecdotal evidence that "some solicitors who want to retire are unable to sell their Firms as no Firm is prepared to run the risk of being classed as a 'successor practice'" for professional indemnity purposes. We have earlier in this Report discussed the underlying adverse selection problems, and here simply note that, since 2009, the SRA worked to make the successor practice rules more flexible, in particular by allowing the option of having resort to the run-off cover of the closing firm, rather than the liability always resting with the successor firm.

7.2.5. Wider client protection arrangements

The extent to which the indemnity insurance requirement, including the run-off insurance requirement that is due on closure, is proportionate should be considered in the context of what other provisions are in place to protect clients' financial position in such circumstances. There are a number of such provisions, including the following.

7.2.5.1. Solicitors Indemnity Fund

The Solicitors Indemnity Fund (SIF) is a single fund financed by payments from practitioners that provides additional protection against claims ("supplementary run-off claims") after the six-year

⁵³ The Law Society (2013), *Professional indemnity insurance*, January, <http://www.lawsociety.org.uk/advice/practice-notes/professional-indemnity-insurance/>

⁵⁴ Solicitors Regulation Authority (2009), *Solicitors' Indemnity Insurance Rules Successor Practice Definition*, <http://www.sra.org.uk/sra/consultations/successor-practice-definition.page>

run-off cover in the master policy specified by the SRA has expired.⁵⁵ It therefore provides additional protections for consumers, although in its guidance notes the Law Society says of the SIF that “*The rationale behind this provision is to give peace of mind to retired former principals whose firms closed with no successor practice.*”

7.2.5.2. Compensation Fund

There remains a Compensation Fund established and maintained by the Law Society to make grants in respect of compensation claims. Under the *SRA Compensation Fund Rules 2011*⁵⁶ all authorised bodies make contributions into the fund, with the amounts determined by the SRA.

The Fund is in place to replace money misappropriated or not accounted for because of a defaulting practitioner (or that practitioner's employee or manager). Grants may also be provided to pay compensation in a civil liability case where that practitioner should have had, but did not have, indemnity insurance.

It is at the discretion of the SRA whether or not to provide a grant out of the Fund. There is therefore a back-stop protection for clients if a firm closes without indemnity insurance, although the maximum pay-out is £2 million per claim.

As with the SIF and any other consumer protection measures funded by individual professionals and/or practices, the Compensation Fund has the effect of raising costs, at least some of which can be expected to be passed through to consumers as a whole, through higher fees. Indeed, depending upon the precise details of the market context, the pass-through can be in excess of 100% (fees/prices increase by more than costs). A simple example is when economic conditions are such that fees/prices are set as a constant *percentage* mark-up on costs.

Thus, as for targeted consumer protection measures more generally, it should be recognised that protecting sub-groups of consumers can potentially be harmful to the welfare of consumers in aggregate, for example because the level protection, and hence the costs, are very high.

7.3. Other factors affecting exit

Our research and discussions with stakeholders has pointed to a number of other non-regulatory factors that affect the costs of exit, and in some cases the ability to opt for succession. These are highlighted here since they interact to some extent with the assessment of regulatory requirements. They include:

- A general commercial barrier to exit identified in our interviews is a ‘lack of buyers’ for some types of firms, particularly traditional High Street practices. The SRA also notes, in *Risk Outlook 2013*, that firms may struggle to put in place an exit plan because of “*limited opportunity to sell their businesses due to time pressure, as successful business sales often*

⁵⁵ The SIF also underwrites the following exposures: (a) claims made during the period a firm was covered by the SIF master policy (i.e. notified from 1 September 1987 to 31 August 2000) i.e. ‘historic SIF claims’; (b) claims made after 31 August 2000 by practices that ceased while covered by the SIF master policy i.e. ‘SIF run-off claims’.

⁵⁶ Solicitors Regulation Authority (2011), *SRA Compensation Fund Rules 2011*, Rules dated 17 June 2011, <http://www.sra.org.uk/solicitors/handbook/compfund/>

take years to plan".⁵⁷ As one interviewee put it to us, the biggest practical problem with closing down is "*finding someone who is prepared to take over the firm, and pay you out for it*". Even where a suitable buyer is found, the settlement can often occur over a number of years; for example, the retiring owner may be paid out from their practice over a period of three years. These types of staged withdrawals were seen to increase the risks for the retiring party that the new owners of the firm might encounter financial difficulties during the period of pay-out.

On the other hand, the evidence on numbers of mergers suggests a very active market in acquisitions, at least over the last two to three years. Possible explanations for the apparent gap between some perceptions and market evidence include the following:

- Some interviewees may have had earlier time periods in mind, when the market was less active.
- It may simply be that a number of would-be sellers are disappointed by the amounts that buyers are willing to pay for their practice, for example because of adverse selection problems (which may have become more intense in recent years as the number of financially-stressed businesses in the market has increased).
- One (non-lawyer) interviewee who facilitated acquisitions was adamant that many practitioners seeking exit had an inflated view of what their businesses were worth, and that this was due to a lack of commercial skills (rather than to adverse selection problems).

We note that the latter two points are consistent with one of the indicative results of the survey: 'the likelihood of an inadequate purchase price' was expected by the majority of respondents to be the biggest obstacle to a sale of their business.

- We were told that, historically, a typical process of succession was one where a few years prior to closure (retirement) a practice would take on a new, younger solicitor who would ultimately build up contacts in the practice and then take over the practice. However, it was suggested that this process is not as easy as it used to be for many small practices. This was attributed to the fact that younger solicitors have different expectations, and are often seeking to build a career in a bigger firm in a town or a city. One partner in a High Street firm reflected that it was by no means automatic that a younger lawyer would have the desire or expectation to remain at the firm where they trained with a view to ultimately becoming a partner in that firm. He reflected that "*I also see that trainees may not have fixed goals to stay in the law at all. That is very different from my day and partly reflects Gen Y issues but also the uncertain economic situation*".
- For some sole practitioners there may be no plan for succession at all. We were told by a recently retired solicitor that it is not unusual for a sole practitioner to operate as very much

⁵⁷ Solicitors Regulation Authority (2013), Risk Outlook 2013: *The SRA's assessment of key risks to the regulatory objectives*, July, p 30, <http://www.sra.org.uk/solicitors/freedom-in-practice/ofr/risk/risk-outlook.page>

- a ‘sole trader’ with minimal if any administrative support, still less associates who might be expected to take over the legal practice at retirement.
- A further issue noted in our discussion related to the role of banks in providing credit and assistance when firms are going through difficult times. It was suggested to us that banks were not very helpful in this respect, and that, in some cases, in order to stay afloat firms had to seek financing from specialised third-party lenders. However, this observation must be set against other comments made to us that banks may have been too ready to lend in the past and that this has been a contributory factor to business failure more generally, with the legal services sector being no different.

7.4. Assessment of effectiveness of exit rules

7.4.1. Indemnity insurance requirements

Run-off indemnity insurance is required to cover costs associated with clients making claims for poor advice being provided or similar, even after a firm has ceased operating. The main rationale is therefore consumer protection, although we note that, more generally, professional indemnity insurance plays a major role in protecting solicitors in a practice from performance failures on the part of one or more of their number: that is, it is not just about clients/consumers. We also note that specific run-off arrangements are required because professional indemnity operates on a ‘claims made’ rather than on an ‘occurrence’ basis.

There is a direct cost for the party responsible for the closed firm (e.g. retired individual or succession firm) and the premiums can be high. The premiums for a succession firm may be higher, depending on the relevant business arrangements. Moreover, as we understand matters, run-off cover for a closed firm with no successor practice will not be a tax deductible business expense, and this will raise the net costs of practitioners who close their business in this way.

We heard from insurers that, in a number of cases of closure without a successor practice, solicitors may simply ‘walk away’, without making run-off insurance payments. In such cases, the SRA rules require the insurer to continue to bear the liabilities, although the insurer can pursue the solicitor for recovery of the relevant amounts. We were told that, when this happens, the success rate (in achieving recovery) is not high, and non-payments obviously raise insurance rates, and hence insurance costs, for other practices. Again, then, whilst some consumers benefit, there is no free lunch: higher costs can be expected to lead to higher legal fees.

Work by Charles River Associates (2010)⁵⁸ for the SRA on compensation and indemnity insurance was undertaken around the expectation that compensation arrangements should:

- *“protect clients from financial loss caused by impropriety of firms, such as negligence, dishonesty and insolvency”*; and
- *“protect the reputation of the profession from the actions of individual solicitors”*.

⁵⁸ Charles River Associates (2010), *Review of SRA client financial protection arrangements: Report prepared for Solicitors Regulation Authority*, September, <http://www.sra.org.uk/sra/how-we-work/reports/cra-financial-protection-arrangements.page>

The existence of a client-protection requirement is common in sectors where customers are not well placed to judge the quality of the product they are buying. For example, registration with the General Dental Council requires a dentist to have adequate indemnity insurance in place.⁵⁹ In the dental case there are no restrictions governing from whom the insurance is obtained (i.e. no preferred insurers). There do not appear to be mandatory requirements relating to insurance after the dentist stops practising, perhaps reflecting the fact that claims are more likely to be made at the time of an incident.

Similarly, the Institute of Chartered Accountants in England and Wales (ICAEW) makes it compulsory for all members to have professional liability insurance.⁶⁰ The insurance must be provided by a 'participating insurer' that has met the Institute's minimum requirements. The ICAEW also has an ARP arrangement for firms that cannot obtain insurance in the market, providing temporary cover for two years. Furthermore, an accountant should have insurance in place to cover claims made up to 24 months after they cease to practise/provide advice – a significantly shorter duration than the required six year run-off cover in the case of solicitors.

The recent Law Society note on *Professional indemnity insurance*⁶¹ says that the market for professional indemnity insurance has been difficult up to 2012 but may now be picking up. The Law Society notes that some qualifying insurers exited the market, others narrowed the type of firms to whom they offered cover, and there was a general increase in the amount and value of claims. This is likely to have made it more difficult and more costly to obtain insurance. The Law Society found that sole practitioners, small firms (less than five PCHs) and firms doing conveyancing work were most affected. There is also a wider concern about firms, particularly small firms, using cheaper, unrated insurers, arising from perceptions that there is greater risk of unrated financial insurers falling into financial difficulties.

7.4.2. Client management and notification requirements

The SRA guidance note *Closing down your practice* says that “*archiving closed files is one of the highest costs of closure*”.⁶² However, requirements such as record retention and notification requirements were not seen to be particularly onerous by those we interviewed. Indeed, a number of practitioners we spoke to suggested that they would undertake these steps even in the absence of a specific regulatory obligation to do so.

The surveys indicated a fairly wide, though far from universal, familiarity with the various steps involved in closing down a business, as set out by the SRA and in a Law Society practice note. Of those who responded to the question, 70% said they were familiar with requirements and 30% said they were not.

⁵⁹ General Dental Council, *Indemnity Factsheet*, <http://www.gdc-uk.org/Newsandpublications/Publications/Publications/indemnity231110.pdf>

⁶⁰ Institute of Chartered Accountants in England and Wales (ICAEW) Website, *Professional Indemnity Insurance*, <http://www.icaew.com/en/members/practice-resources/practice-management/practice-regulation/professional-indemnity-insurance>

⁶¹ The Law Society (2013), *Professional indemnity insurance*, January, <http://www.lawsociety.org.uk/advice/practice-notes/professional-indemnity-insurance/>

⁶² Solicitors Regulation Authority (2013), *Closing down your practice*, 10 May, <http://www.sra.org.uk/closingdown/>

In other sectors requirements on keeping client documents or similar are not as clear cut, but the expectation is that client confidentiality requirements, such as those that exist under the General Dental Council's principles in the Standards for the Dental Team (from September 2013)⁶³, continue to apply when a practice is shut-down.

We note that the regulations applying to solicitors appear to be as onerous in cases of selling a firm where there will be a successor practice as they are for shutting down. This may not be proportionate, although requirements to obtain client permission before transferring files and client monies seems appropriate. It might be helpful to have distinct arrangements for succession relative to closure rather than bundling the two together, although since the problem is not a particularly significant one in the first place, costs of change may be greater than any benefits that would result.

7.4.3. Run-off insurance requirements

In all of our research and discussions the most important matter that arises in the context of discussions of closure are the requirements in relation to run-off insurance. The requirement to obtain run-off insurance is seen by many to be the most important 'barrier' to exit in the industry. It was also the factor that was most mentioned in the 'other comments' sections of the surveys, and it was the most familiar of the regulatory requirements surrounding closure of businesses, suggesting that it is a factor that has 'got the attention of practitioners': whilst 30% of respondents indicated lack of familiarity with closing down requirements in general, only 7% said they were unfamiliar with run-off cover requirements. Interviewees who had not considered exiting the profession, including those who were some years off retirement, viewed run-off cover as a significant issue that merited attention when considering how barriers to exit might be alleviated.

However, the views we have heard differ as to whether the requirement to have run-off insurance for six years is proportionate to the risks. The following points, among others, emerged:

- Although most participants were familiar with the basic concept of run-off cover, there were exceptions who asked us to explain it to them. One solicitor who was in the process of applying for authorisation from SRA did not know about the requirement even though she was currently in discussions with insurers. It appears that not only was the existence of the requirement for cover unknown to her (an issue about her own familiarity with the regulation) but also that the cover had not been explained to her.
- Some people we have spoken to indicate that they are happy with their current level of insurance premium, and that, over time, they have been able to obtain progressively better deals on insurance. Since run-off premiums depend on current rates, this view tends to be linked with more favourable views of run-off rates.
- One interviewee highlighted the importance of run-off cover as protection not only for clients and the profession but also for lawyers themselves who might be faced with a claim in retirement. She cited one story of a former solicitor she represented in a professional

⁶³General Dental Council, *Standards for the Dental Team*, [http://www.gdc-uk.org/Dentalprofessionals/Standards/Documents/Standards for the Dental Team - web PDF.pdf](http://www.gdc-uk.org/Dentalprofessionals/Standards/Documents/Standards%20for%20the%20Dental%20Team%20-%20web%20PDF.pdf)

negligence claim who did not have run-off cover and lost her home as the result of the claim. This is a particular illustration of the more general point we have made above: personal indemnity insurance is not a requirement that can be said to be motivated by consumer/client protection alone: it has significant benefits for lawyers.

- Some interviewees said that they had not thought deeply about run-off cover because they did not need to. They did say, however, that they would expect such cover to be a “significant” or “substantial” cost of closing down. In the same way, they could see the incentives to run-down the practice close to retirement so as to reduce the amount of run-off cover that would eventually be payable.
- Other interviewees, however, described the run-off insurance requirements as ‘punitive’, and argued that there is insufficient tailoring of insurance premiums to the specific risks associated with particular practices.
- Interviewees have also questioned the amount of the premium and the time period for recovery. One interviewee confessed that he had *“never been able to understand the approach to run-off insurance and why the premium cannot be annualised: you pay for liability incurred in the relevant year and if there is a claim the insurers sort it out amongst themselves. You do not pay for motor vehicle insurance after you have sold your car, even if you can incur liability for an accident you caused prior to selling the vehicle.”*

These differences in perspectives may reflect differences in the underlying insurance premiums that are being paid by different types of law firms, although that is not a matter that we have had time to explore in any detail. The different viewpoints may also be influenced, to some extent, by the immediacy of the issue for the individual involved. This is summed up by one interviewee who confessed that he tried not to think about the matter as he did not expect to retire very soon.

7.4.4. Risk of inefficient exit decisions

We have identified two situations where high barriers to exit might result in exit decisions that are not efficient and which, in themselves, may hamper the objectives and principles of the SRA.

1. Disorderly exit: a firm may close but choose not to meet the SRA closure requirements in order to avoid the costs involved. The higher the exit costs, the higher the incentives for disorderly exit.
2. Continued, minimal operation where exit is efficient: a regulated firm may choose to remain authorised and offer a minimal, scaled-back service, to avoid the costs of shutting down and/or because it is difficult to identify a suitable succession firm.

We also note that, as discussed earlier, the existence of barriers to exit will affect entry decisions and decisions to change business structure. Furthermore, the SRA identifies “lack of adequate supervision planning or exit planning” as one of the emerging risks for the regulator in the *Risk*

Outlook 2013.⁶⁴ This highlights the fact that disorderly closure has consequences for regulatory costs as well.

7.4.4.1. Disorderly exit

In this situation clients could be left, unexpectedly, with no representation and there may be no insurance in place to cover future claims. This would damage the reputation of the legal services profession generally and could, in the absence of other provisions, leave individual customers, creditors and others with a financial loss.

In *The Risk Outlook 2013* the SRA notes that it is “*seeing an increased number of firms becoming unable to continue trading with no viable exit or succession plans in place.*” The SRA notes in this context that the firm may not be able to manage financial difficulty and may put consumers’ interests at risk if there is disorderly closure, and that disorderly closure can “*cause delays in clients accessing their files and funds. It may also affect other parties to transactions or litigations and so impact more widely, including on the courts and the administration of justice*”.⁶⁵

The SRA further claims in *Risk Outlook 2013* that being in financial distress is more likely to result in a firm providing poor standards of service and more generally breach SRA principles. It may also increase the likelihood of criminal activity by the firm or individuals within the firm. There is also the impact on creditors to consider (the SRA notes the case of Cobbetts which left unsecured debt of over £91 million) which is not within the SRA’s remit, but does affect confidence in the regulatory framework.⁶⁶

Whilst we think that all of these things are possibilities, we also believe that it is possible to exaggerate their significance. Of risk, it can be said “*seek and ye shall find*”: since it is all around us, at all times and everywhere. Three general points can be made.

First, there are direct incentive effects working against disorderly exit, which are arguably stronger in legal services than in many other markets. Individuals’ reputations are at stake and in the legal services market reputation matters if an individual wants to be able to practice in the future. Standard reputational effects, increasingly strengthened by the ease of communication among consumers made possible by the internet, are reinforced by regulatory requirements, most obviously the prospect of loss of a practising certificate.

Second, there are several of provisions in place to protect consumers in the event of a prospect of disorderly exit – intervention, indemnity insurance, the Compensation Fund, the Ombudsman service, general law – and these are clearly relevant when assessing whether any changes to exit regulations are required because of generally increasing financial pressures on practices that might increase the frequency of disorderly closure.

⁶⁴ Solicitors Regulation Authority (2013), *Risk Outlook 2013: The SRA’s assessment of key risks to the regulatory objectives*, July, <http://www.sra.org.uk/solicitors/freedom-in-practice/ofr/risk/risk-outlook.page>

⁶⁵ Solicitors Regulation Authority (2013), *Risk Outlook 2013: The SRA’s assessment of key risks to the regulatory objectives*, July, p 24, <http://www.sra.org.uk/solicitors/freedom-in-practice/ofr/risk/risk-outlook.page>

⁶⁶ Solicitors Regulation Authority (2013), *Risk Outlook 2013: The SRA’s assessment of key risks to the regulatory objectives*, July, p 24 <http://www.sra.org.uk/solicitors/freedom-in-practice/ofr/risk/risk-outlook.page>

Third, there appears to be little or no empirical evidence on the magnitude of the possible effects of financial difficulties on the performance of practices, and hence on the welfare of their clients/customers (see further below).

7.4.4.2. Continued operation at a minimal level to avoid exit costs ('zombie firms')

If, for an individual firm, the costs of exit are higher than the costs of running a minimal service the latter option may be chosen. Such cases have attracted the label 'zombie firm', although it is not clear that the usage is consistent with the meaning of the term in other contexts, where it tends to refer to continued operations in circumstances where a future, highly likely *economic* event can be expected to force closure. In the current context, there is no anticipated *economic* triggering event: the notion appears to apply to small, traditional law firms that (usually older) proprietors choose to keep open, typically at lower level of activity than previously, rather than to close down, perhaps until incapacity or death takes its toll. This might less pejoratively be described as 'phased retirement'.

There is no immediately compelling reason why the existence of 'zombie firms' should be considered a problem in relation to the overall flexibility and adaptability of the market. It is true that it retains a higher level of supply in the market, and therefore makes entry and expansion more difficult for other firms who may be more efficient than those hanging on. On the other hand, the extra supply will tend to depress prices, to the benefit of consumers, and the usual word for this state of affairs is 'competition'.

There are nevertheless a number of potential risks that could be associated with such a firm, the majority of which stem from the possibility that the firm's proprietor(s) would prefer not to be operating (i.e. the 'phased retirement' is in some sense or other a forced outcome). It can be argued that there are risks of such minimalist operation, for example:

- There is a higher probability of disengagement from work, and associated poor quality of service, putting SRA principle 5 (to provide proper standard of service) at risk.
- It is more likely that the employees in the firm will not meet other regulatory requirements, for example in relation to CPD or training of employees, which would have further consequences for the quality of advice provided and compliance with SRA principles and outcomes.
- The firm may eventually fall into financial distress and/or be found to breach a number of SRA regulations and require significant intervention by the SRA, with associated higher regulatory burden and costs.
- Indemnity insurance cover may not be sufficient to cover future claims, particularly given the higher risk of poor decision-making which may not be captured in premiums based on previous years' turnover.

SRA regulations can influence the decision to exit or continue to operate a minimal scale business in two ways. First, the direct costs of closure, particularly relating to run-off insurance, may be a significant barrier to exit for some firms. Second, more indirectly, the SRA regulations relating to entry and business structure changes may limit the number of firms that are willing to enter the

market and provide a succession option to firms that want to shut down. Thus, we are faced with the question: is disproportionate regulation serving to increase the above risks?

We see no very strong reason for concluding that it is. First, the risks identified above are, in effect, only one side of the balance sheet. It can equally well be argued that:

- Some practitioners might prefer a gradual run-down of work to a ‘cliff-edge’ retirement.
- Many closures involve smaller practices run by older practitioners. Advancing years have some disadvantages in relation to performance, but they also have advantages (greater experience, wisdom, concern for others, etc.)
- With less activity undertaken, there may be more time for those clients who remain.

More important, we have made various enquiries as to the possible magnitude of the numbers of firms operating in a manner that might best be described as ‘near dormant’. We distinguish these circumstances from those of a traditional, small, High Street practice with relatively elderly principals, operating in what has become an increasingly difficult market. There is little doubt that there are many such practices for which activity levels and revenues are under pressure, and for which finances have deteriorated. These are different circumstances from near dormancy however, since the latter implies a minimal level of activity, not just a reduced level of activity.

What we heard were responses that can be accurately summarised in the statement: *“There must be some firms operating like that, but I don’t actually know of any myself.”* Only one interviewee claimed to have encountered such a practice, once. More specific points include:

- Most interviewees thought that the requirement to maintain run-off cover was likely to be an important factor in any decision to run a practice down before closure.
- Some respondents suggested that where firms’ activities declined to low levels it most usually reflected wider issues such as: poor case management systems, a failure to embrace technological change, poor financial planning and the characteristics of some legal practices which are slow to embrace competition and where the operators of such firms are reluctant to take advice. That is, the downsizing was a consequence of poor performance, not a conscious decision to try to reduce costs of exit.
- One interviewee noted that while operators of such firms might like to attribute enforced continuation to the regulatory requirements associated with shutting down, in fact, it was “all in their head”, and their position often reflected an inertia and a failure to embrace a changed marketplace. The preservation of their existing status as a solicitor ‘in practice’ might also, in part, reflect an element of professional pride.

7.4.5. Future trends in exit

Given the focus of the study, it may be relevant to record some of the more general views that emerged from interviewees concerning the nature and frequency of future exits.

- Despite some growth areas, there are likely to be significant further exits from the market. Some may be due to the retirement of sole practitioners who have not made succession plans; others may be casualties of the economic situation, particularly in those practice

areas that are worse hit by the recession (property, conveyancing), cuts in legal aid work (e.g. crime, family law), and statutory changes in the personal injury area. One insolvency practitioner remarked that he expected to see more law firm closures: *“I believe it is only a matter of time before that will occur with greater frequency. We have already seen it with the big names such as Halliwells, Dewey etc.”*

- Although a solicitor with three years of post-qualification experience may in theory set up his/her own practice as a sole practitioner, including by acquisition of an existing practice whose principal is seeking exit, this option may sometimes not be accessible. Our interviews with insurers suggest that such a practitioner would be considered high risk and would therefore need a compelling business case to obtain and retain the necessary insurance required to stay in practice. For such a junior practitioner, working as a paralegal, particularly an agency paralegal, might be a more likely option. One trainee predicting his future beyond qualification described this situation as *“a form of purgatory [...] Many paralegal jobs are also temporary, offering very little security.”*
- As noted earlier, but worth restating because of the frequency of references by interviewees, a common theme among solicitors, regulators and third parties is that many existing practices have limited business management skills. Whilst there are examples of innovative business models, a concern was expressed as to a lack of engagement with the realities of running a business. This phenomenon is a factor likely to contribute to business failure if it is not addressed in a timely manner. As one interviewee commented: *“Clients are becoming more sophisticated and want more from their lawyers – whether businesses or individual consumers. Consumers are operating in an online world. They want to communicate by email, they want their phone calls returned today. It sounds very simple but many lawyers are still operating in the 1960s using paper post, 9-5 (and closed for lunch) opening hours and not changing with the times. The general philosophy is one of “live for today and don’t worry about marketing.”*
- A number of interviewees remarked that ABSs posed the greatest threat to firms at the lower end of the market who competed mainly on price and volume, as well as sole practitioners. They felt that the exit of some such firms was inevitable. On the other hand others emphasised that the introduction of ABSs was doing no more than crystallising an ongoing trend that was happening in the market anyway, with smaller firms, particularly those not operating in specialist niches, coming under increasing pressure in a tough market.
- In order to increase their options when facing exit decisions in the future, firms will need to address the business realities sooner rather than later. Some interviewees believed that lawyers may be particularly reluctant to see and take action to address potential future threats to their business. As one insolvency practitioner put it: *“lawyers are averse to seeking help, perhaps more so than trading businesses. With a sole practitioner the options for recovery later in the demise cycle may be limited. Unless they have incorporated themselves as a company or other limited liability structure, there may be few alternatives to personal bankruptcy. It may seem obvious but the earlier a problem is addressed, the more options and flexibility there is to avoid the collapse of the business”.*

This last phenomenon may, however, be less specific to the practise of law than is implied. Loss in painful, but so is the contemplation of loss – regardless of trade or profession.

The general evidence to the effect that significant levels of exit can be expected over the next few years was also supported by the responses to the surveys: 56% of respondents to the relevant question indicated that they had contemplated retirement or closure of their business over the last five years.

7.4.6. Interim conclusion on exit

In section 3 we commented that the SRA statistics on practice closures suggested that there might be more significant issues concerning barriers to exit than concerning barriers to entry. In the event, and taking account of all the evidence available, we do not believe that this is the case.

In fact, the gross rate of exit – the number of practices disappearing as a result of either amalgamation or closure – has been over 10% per annum in 2011 and 2012. That is more than one in ten practices per year have ceased to operate. As the effects of changes to legal aid and personal injury insurance bite, it appears unlikely that this exit rate will fall soon.

Run-off insurance cover is the only significant barrier to exit by closure that we have been able to identify. However, as indicated at the outset, it results from the adoption of a claims-made basis for professional indemnity insurance rather than a losses-occurring basis, as a number of interviewees recognised. This could, in principle at least, be changed, but, if a shift to occurrence-based insurance were to be contemplated, the full economic consequences should properly be recognised. For example, annual premium rates for new entrants in the early stages of their lives could be expected to rise, since the annual rate would need to cover the extra liabilities arising from conduct in those years which triggers claims in later years. If, as the evidence suggests, exit rates are on average higher for younger firms, the magnitude of the effect could be significant.

The residual issue is the tax treatment of run-off insurance. If, as we understand to be the case, the costs of such insurance cannot be set against tax liabilities in the event of simple closure of a practice, that is an asymmetry that gives rise to an unambiguous and potentially significant barrier to exit. We note, however, that the extra cost can be avoided if exit can be arranged via amalgamation or acquisition leading to a successor practice that takes responsibility for insurance to cover potential liabilities, in which case the relevant *premia* are tax deductible,

It is also relevant to note that, on balance, regulations may serve to establish incentives for *too much* exit of practices from the market. Thus, the specification of minimum terms and conditions of insurance which practices are required to obtain in order to be authorised may force some economically viable practices out of the market. Intervention by the SRA leading to closure of businesses may have a similar effect, particularly if an asymmetric approach to risk is taken, i.e. if intervention is motivated in response to a perception that things may go wrong, which is not counterbalanced by any recognition that forced closure automatically closes off the possibility that things may actually go right.

Indeed, we suggest that great care needs to be exercised in using intervention powers to close down practices. In competitive markets, for example, it is not the case that businesses necessarily close when they cease to be profitable. Normal commercial calculus says that the exit decision should

take account of the 'real option value' of staying open, which derives from (a) the possibility that profitability might be regained and (b) the avoidance of exit and re-entry costs in the event that a profitable future does re-emerge. Moreover, other things equal, the removal from a market of capacity to supply can be expected to introduce upward pricing pressure into that market.

8. OVERALL ASSESSMENT

8.1. The project specification and the project findings

As indicated in the Introduction, among the requirements set out in the specification for this study (see Annex 1) was that the research should:

- Identify barriers to market flexibility in the entry, exit, merger or other changes in business structure (e.g. mergers between solicitor and conveyancer firm), ownership or finance.
- Identify the specified or implicit aims of barriers and their cost/benefits.
- Assess the extent to which the barriers protect consumers or meet other intended aims.

Exemplary potential (regulatory) barriers to exit mentioned in the specification were:

- Required run-off insurance cover.
- Duties to clients in the event of close down.
- Retention of records after firm closed.
- Requirements on firms to ensure the suitability of a buyer.
- Market for individuals or firms looking to purchase solicitor firms.
- Legal requirements on dissolving partnerships.
- Tax liabilities on firms seeking to close or dissolve partnerships.
- Run off requirements where firms are transitioning to a new business form e.g. solicitor firm to conveyancing firm.

It was anticipated that it would be possible to classify those regulatory requirements that had implications for barriers to entry, exit and mobility according to something like the following scheme:

- Those requirements not focused on a clear objective and so largely unnecessary.
- Those focused on a clear objective but the objective could be achieved in a more proportionate, alternative way.
- Those focused on a clear objective and are well designed, but through poor delivery prove disproportionate,
- Those that are both focused on a clear objective, proportionate and well delivered.

We have found that, for the initial exercise that involved assessing regulations on a requirement-by-requirement basis, the findings of the study can indeed be presented in this way, and quite quickly. With the possible exception of run-off insurance cover, we found that each of the major regulatory requirements can be linked back to some or other aspect of public policy objectives. However, it is not usually possible to say that a particular requirement is focused on a clear objective, because of the way in which objectives are specified, which is in a general way with considerable overlaps. One requirement may affect multiple objectives, whilst one objective may be served by multiple requirements and with no expressed or readily apparent connection between them. There is, therefore, no very close targeting of regulatory requirements. Moreover, given the flexibility to the SRA available under the risk-based regulatory philosophy that has been adopted, it is difficult to say that any of the relevant *detailed* requirements could (again with the possible exception of run-off insurance) be said to be disproportionate *in principle*.

This shifts the focus to consideration of larger sets of regulatory requirements (such as those most directly concerned with relationships with consumers/clients, or with commercial matters such as business models and structures) and of the practicalities of enforcement of the regulatory philosophy, both of which are, for reasons explained at the outset, relevant potential determinants of barriers to market flexibility. We note, however, that assessment of enforcement is an exercise that poses difficulties for desk-based research because of (a) the relatively short time period over which the reformed regulatory system has been operating and (b) the inherent limitations of the number of ‘observations’ that are possible in a study of this nature. As explained in earlier sections, there is also clearly a learning process that accompanies such a major change as the one that has occurred in legal services regulation in England and Wales; and, in the earlier stages of this process, only really major flaws are likely to be identifiable from the statistical record or from a forensic analysis of the regulations themselves. The interviews were, therefore, crucial in giving us a feel for the first-hand experiences of practitioners and, in the event, we conducted a significantly larger number of interviews than originally intended.

The interview results were fascinating in that, when discussing the detail of regulation, the general theme was that, when each was considered on a stand-alone basis, few or none of the individual regulations, other than for run-off insurance, was particularly problematic (there were, of course, exceptions to this in particular interviews, but such interviews tended to be in the minority). By way of illustration, in relation to the list of potential exit barriers set out above:

- The dominant view was that duties to clients in the event of closure, including retention of records, were not significant burdens and were, in any case, matters that responsible professionals could be expected to address, even in the absence of entity regulation.
- Similarly, the market for acquiring solicitors’ practices from those wishing to retire or move on to other things was considered to be an active one, and regulation-induced barriers to finding suitable buyers was not thought to be a major problem – which is different, of course, from saying that vendors were happy with the prices on offer.
- No major issues were raised by interviewees about partnership dissolution and/or the tax consequences thereof. These are clearly difficult areas where general legal requirements impose significant costs, but the issues are not unique to the legal services sector and there was no sense that the SRA regulations themselves made life much more difficult for practitioners.

As stated, the exception was run-off insurance, where the majority view was that exit costs were significantly raised by its existence, and that this was an effect that was attributable to SRA regulation, which sets out quite stringent minimum terms and conditions for required professional indemnity insurance.

Whilst we agree with this majority view, there are some complications that need to be taken into account before concluding that there might be a better way of doing things. If the ability of insurers to make specific charges for mandatory run-off cover were restricted, such that the relevant liabilities were covered by the annual insurance premium in the last period before a practice’s closure, it is to be expected that annual insurance *premia* would increase, to cover the costs to insurers of the now unfunded post-closure claims. Although we would not expect the effect to be large for long established firms, such a change could be expected to raise entry costs: an insurer

making an offer to a new entrant would recognise that, if the entrant exited quickly (a not infrequent occurrence in markets generally, since entry often has some element of experimentation about it), the insurer would be taking on liabilities associated with claims made after exit, without prospect of collecting any additional payment for so doing.

There is nevertheless one potential distortion that arises from the interaction between current SRA requirements and the tax regime and which might be avoidable. As we understand it, run-off insurance consequent on closure cannot be offset against revenues in pre-closure periods, which adds to the height of the perceived financial hurdle over which closing practices have to jump. The problem is mitigated to the extent that closure can be combined with the passing-on of liabilities to a successor practice, but this may not always be feasible, for example because of adverse selection problems (i.e. potential buyers fear that those wishing to sell businesses may be particularly prone to future claims).

The quantitative extent of any such problem is uncertain, but we were told by insurers that there were certainly cases of closing businesses that did not pay the run-off premium. Any tax-induced increase in the size of the financial liabilities triggered by closure can be expected to tend to increase the frequency of such non-payment, and hence to contribute to greater incentives for disorderly closure of businesses. It is, therefore, an issue that merits at least some further consideration. We note, however, that whilst more favourable tax treatment of run-off cover would tend to ease exit and mobility barriers, it would tend to reduce HMRC revenues. Thus, although the impact would likely be small, there would be a more general cost of making such a change. Tax reform would also obviously have a much wider domain of application than the solicitor profession alone.

The general finding that individual regulatory requirements, each considered on its own, do not appear to give rise to significant barriers to entry, exit and mobility is not, however, the end of the story. A combination of individual regulations can give rise to significant cumulative effects, even though each individual effect is small. Moreover, there are inherent uncertainties about the enforcement of the regulatory arrangements, which are best illustrated by what it is that firms are expected to do in the event of amalgamation or other forms of business restructuring. Since the general regulatory objectives are high-level and overlap with one another, much will rest with the discretion of the SRA in deciding whether or not a particular proposal is compliant with the regulations. Practices will therefore need to form a view on how the SRA sees the (uncertain) links between the practices' plans and the 'outcomes' that are of relevance to assessing compliance, and, in forming a view about how the SRA will view matters, practitioners in a merger situation will potentially have to trawl through a large volume of regulations and guidance.

There is evidence from both the market and from interviewees that such cumulative effects of regulation do have a restrictive effect on market performance. We remarked in section 3 that, whilst practitioners in aggregate have responded to market shocks, and whilst they have done so in substantive ways, the responses appear to have been slower than those of businesses in many other sectors. This fits with more general perceptions, articulated in the Clementi Report and in many other places, that lawyers have been rather slow to adapt to and to use new technologies, and have, in many cases, been lacking in the business skills that might be expected in firms with comparable revenues in other sectors.

In the interviews, there was widespread recognition of these latter points, and those we talked to were certainly not in a state of denial about market realities or the challenges they faced. At the same time, significant doubts were expressed by interviewees about whether the existing regulatory arrangements were helping improve matters; and, to repeat, the concerns were more to do with the cumulative impact of the arrangements than with any particular part of the SRA regulations.

Our own conclusions are a little more definite, and are as follows:

- There are good reasons to think that, in their current form and as currently enforced, significant sections of the regulatory arrangements may be serving to impede innovation, and hence to be impeding market flexibility and adaptability. To be precise, we think the problem is not so much that regulation raises barriers to entry, exit, and mobility *across the board*; but, rather, that it raises barriers to innovation via what might be referred to as ‘tilts’ or distortions to firms’ decisions concerning entry, mobility and exit.
- Even if, on more detailed consideration, it is considered that these ‘tilts’ are not sufficient to be a major concern for policy, it is still the case that there is little or no evidence that significant parts of existing regulations do any good whatsoever (in contributing to high-level objectives). That is, they produce no clear, demonstrable benefits, but do impose significant enforcement and compliance costs, which are ultimately likely to fall in large measure on consumers.

We now explain the reasoning behind these statements.

8.2. Entity regulation and the *ex ante* supervision of financial arrangements, business models and governance

Entity regulation has been explained by the SRA in terms of its contribution to the public interest and client protection but, so far as we can see, its justification has no very direct connection to any of the LSA objectives other than that of promoting and protecting the interests of consumers, via client protection. It may have indirect implications, but these arise via its impact on client protection, so that, if it fails to protect clients in a proportionate way, it will almost certainly fail on other criteria too. Indeed, we think it likely that parts of the regulations have directly negative effects on other LSA objectives, such as the promotion of competition.

Our chief concern is with the implications, particularly for small practices, of those parts of entity regulation concerned with business models and finances. The working regulatory philosophy appears to be that failure of a business creates risks for clients, and that it is worth putting significant resource into regulatory vetting of financial arrangements, business models and firm governance in order to reduce that risk. There is an implicit assumption here that the regulatory activity will be effective in reducing the risks, which is very far from being a self-evident truth, and our first point is that evidence on the point needs to be assessed. Our second point is that, in the course of such an assessment, the wider effects (unintended consequences) of the risk-reduction activity should also be evaluated.

Ostensibly, the SRA does not want to second-guess a firm’s business model yet the experience of some applicants suggests the opposite. As one ABS applicant told us that “[the SRA] looked at

aspects of our business model which did not seem to be that relevant to our fitness to be owners of a legal services firm”.

While the objectives behind these measures may appear reasonable, they come at a cost to consumers. The direct costs are the costs of regulation itself: SRA costs are recovered from the regulated entities, which also have to bear their own compliance costs. Higher practice costs can, in turn, be expected to lead to higher fees. More importantly, such measures can reduce the ability of competition to promote consumer interests: apart from the higher cost base, incentives to innovate are reduced and a number of choices that would, in other ‘markets’, be tested under competitive conditions are simply ruled out. This last point is reflected in an observation of one partner in a niche media law firm who told us: *“remove the requirement for solicitors to maintain insurance. Clients could choose law firms based on whether or not the firm is insured”*. The proposition being put is that a firm’s own risk management can be a source of competitive differentiation and natural selection. A less radical version of the same argument is that insurance should be specified at a lower level of cover than is currently the case, leaving open the choice that some practices may choose to offer more and potentially giving consumers some degree of choice over this dimension of the overall ‘quality’ of the services that solicitors offer.

Comparing legal services regulation with approaches in other sectors and markets we note that, in general, the process that market economies typically rely on to establish sound financial arrangements and good business models is competition, which has been found to be the most powerful single force for promoting consumer interests over the longer term. Within this broad policy framework, additional policy measures may be called forth when there are specific problems to address, which go beyond a general notion of promoting and protecting consumer/client interests.

For example, systemic risk in banking systems has called forth prudential regulation of banks, although, as the credit crunch and great depression (of the 1930s) have shown, the existence of a regulatory system is no guarantee of success and, in some circumstances, can itself be a major source of systemic risk (bank supervision is a monopoly activity, so any regulatory failure is automatically systemic in some sense or other). Similarly, there might be legislation on governance arrangements when economic decision makers are responsible for large quantities of other people’s money, and in legal services this leads to a clear and specific rationale for regulations concerning the handling of clients’ monies.

What is much more difficult to understand is how such financial/business supervision can contribute to the rather general, non-specific objectives of the LSA. There is a possible argument that the collective reputation of solicitors is a little bit like systematic risk in that the bad behaviour of a few can have damaging consequences for the many; but this is an issue already largely addressed, or potentially addressed, by the regulation of individual professionals. The incremental contribution of entity-level regulation of business models and finances is unclear.

What is most likely to convince a client who has suffered from a solicitor’s misconduct of the integrity of the profession as a whole is punishment of the individual responsible and redress for the harm done. These things are accomplished, on an *ex post* basis, through the criminal law, the Solicitors Disciplinary Tribunal, the Compensation Fund, and the Ombudsman service. They are supported by *ex ante* mandatory professional indemnity insurance requirements and the Solicitors Indemnity Fund, which help ensure that sufficient resources are available for compensation

purposes, and by the intervention process which seeks to mitigate the harm that can be done by disorderly closures.

This is a formidable list of mutually reinforcing consumer/client protections, and we have not seen or heard substantiated claims that there are significant incremental benefits to be added by *ex ante* supervision of financial arrangements and business plans. Indeed, if things go wrong because, say, of disorderly closure, and if consumers/clients suffer in consequence, we suspect that the effect of telling consumers that the financial and business arrangements had been judged to be compliant with SRA regulations is likely to be a reduction in consumer confidence in both the regulator (for failing to spot the problems) and profession (who must have hidden the problems from the regulator).

Perhaps more importantly, entity regulation focused on financial and business matters substitutes a regulatory process for a competitive market process. It is the regulator who is responsible for weeding out risky business models. There is no evidence that a non-commercial bureaucracy will be more effective at this task than the process of competition itself.

The strongest argument for the regulatory approach is probably just the simple point that, in the past, competition has not done a good job in weeding out poor financial and business performance; but that begs the question of whether the market was, in fact, effectively competitive in the past. In support of the argument that the market has always been competitive is the point that there was a large number of alternative suppliers among whom consumers could choose; in support of the argument that it wasn't effectively competitive is the past control of the market 'rule-book' exercised by the profession, which is definitionally a form of monopoly power that could be, and was, used to control entry conditions.

We do not need to revisit past controversies here, since, as explained in *Understanding the Economic Rationale for Legal Services Regulation*⁶⁷, the LSA effectively ended professional monopolisation of control of the market 'rule-book', and the work of the LSB and OFT has clearly been pointed toward the promotion of more effective competition in the relevant markets. Financial and business regulation of legal entities therefore duplicates, at least in part, a function that is now being performed in other ways.

Much more significantly, there are reasons to expect that regulation of entity business and financial risks degrades the performance of the alternative that it sits beside. The risk-based approach to regulation means that the kinds of financial and business models that get the most regulatory attention, and hence that are the most likely to be hindered or prevented by that attention, are those that are the most innovative or experimental and that most deviate from familiar and standard models.

This is a well-recognised point in relation to ABSs but we think the issue goes much further than that. For example, restructurings among partnerships may involve arrangements that reflect idiosyncrasies of the particular contexts in which the relevant firms find themselves; and different contexts can exhibit endless variations. Indeed there is a sense in which every business organisation, however large or small, comprises a unique combination of information and resources. Adaptations/innovations made in a merger situation that are not familiar to regulators

⁶⁷ *Op.cit.*

will tend to attract more regulatory attention, including those involving different ways of financing and managing ‘traditional’ lawyer owned-and-managed firms, as well as ABSs.

It can, of course, be argued that such regulation is proportionate because (a) innovation and experimentation are inherently more risky than following tried and tested models and (b), under risk-based regulation, riskier conduct *should* attract more regulation: that is the main point of the approach. Although point (a) is far from always true – in a changing economic environment, innovation and adaptation may be considerably less risky than sticking with older ways of doing things – there is nevertheless some weight in the argument. What needs to be remembered, however, is that regulatory actions aimed at reducing risks associated with innovation frequently tend to impede and slow down the process of innovation, experimentation and adaptation. What may be less transparent, and hence more likely to be ignored, are the consumer benefits that might be forgone as a result of this encumbrance on adaptive, competitive processes.

The trade-off here is a generic one, and the paradigm example is the licensing of new pharmaceutical products. Drugs can be made safer (risks of harm reduced) by requiring ever more stringent testing procedures, but the resulting delays in bringing products to market have costs in terms of denying patients timely access to new products which, if they had been made available sooner, would have brought considerable economic benefits. There therefore needs to be a balancing of the relevant costs and benefits.

To repeat, then, in the market for solicitors the chief concern is not that barriers to entry, exit and mobility will be increased generally by risk-based entity regulation (although we think that is likely to be one of its effects), but rather that regulations will have the more specific effect of increasing barriers for innovative and non-standard adaptations to changing circumstances.

8.3. The problem of poor policy targeting

As explained, it is not possible to identify close links between very specific parts of the relevant regulatory rule-book and LSA objectives, largely because of the very generality of those objectives and the inter-relationships among them. Nevertheless, two of the objectives stand out as being shared in common with a number of other regulators, namely to protect and promote the interests of consumers and to promote competition in the provision of legal services. This commonality in objectives is a source of benchmarks against which the regulatory approach in legal services can be assessed. Even given differences in the market context and in other regulatory objectives, we should, for example, expect to see at least some similarities with regulatory approaches to consumer protection and competition in other sectors.

The SRA is required to have regard to, and to act in a way compatible with, the achievement of these two LSA objectives. Whilst they are not the only objectives and are not given precedence over other objectives, neither are they relegated to a place below the other six objectives. However, when it comes to the setting out of first the Principles and then the mandatory outcomes in the SRA Handbook it is difficult to see any significant connection of these aspects of the regulations with the two LSA objectives cited. In particular, the mandatory outcomes relating to client protection are all concerned with what might be labelled the ‘quality of services’ provided, not with the interests of consumers as such. This would not matter if other sections of the Handbook contained

regulations motivated by a need to have regard to, and to act in a way compatible with, the protection and promotion of consumer interests. So far as we can see, they do not.

It might be said, therefore, that both the Principles and the mandatory outcomes have been developed in a way that is not well targeted on the objective of protecting and promoting the interests of consumers, and the same can be said in relation to the objective of promoting competition. What we have in mind is the obvious point that consumer interests are affected not just by the quality of services they receive, but also by the price that they have to pay for those services. Thus, a gold plated service may be preferred to an inferior service by all, but it may not fit everyone's budget.

This neglect has implications for the way in which regulations are enforced when firms enter the market, when they close down, and when they change their business structures or business models, including via amalgamation. More specifically the SRA says (on its website) of the risk-based approach that:

“Risk-based regulation means that risks to the non-achievement of regulatory objectives are assessed in terms of their likelihood and the impact of any harm they cause to desired outcomes. This approach ensures that regulatory activities and limited resources are prioritised and applied proportionately.”

If, however, the specified, desired outcomes are not closely related to the regulatory objectives, then risk-based assessments triggered by entry, closure, and restructuring will fail to take account of relevant considerations.

The most obvious example relates to entry, because control of entry has been one of the aspects of professional regulation that has come under most attack in the past due to a tendency (in professional regulation's historical versions) to seek to raise entry barriers so as to protect the incomes of incumbents. What risk-based assessment of entry authorisation applications misses out, if it uses desired outcomes as the relevant criteria, is the benefit that new entrants potentially bring to consumers in terms of extra supply to the market (and hence lower prices) and additional innovation.

8.4. The problem of excessive duplication

In the legal services case there is a further factor to consider, which is that the activity of evaluating business finances, business models and firm governance is one that is duplicated: insurers, financiers and firms themselves are interested in these matters too, for obvious reasons. This draws into sharp focus a highly pertinent question: what extra benefits are provided by entity-regulation in these areas? We were not able to discover a convincing answer to this question.

Insurers told us that, in setting rates for a firm, they needed to understand the risks involved, and further that traditional legal models of firm structure were attractive to them (the insurers) because they were familiar and relatively easy to understand. On this basis we would expect that, other things equal, insurance premia would be lower for familiar business structures and strategies than for the more innovative and less familiar alternatives, particularly in cases where the implications

of the latter are less than fully transparent. This, of course, has the effect of raising the costs of innovations/adaptations, and should give traditional structures a competitive advantage, others things being equal; and there is nothing wrong with that in circumstances where the additional costs are proportionate to the extra risks.

The normal market process therefore appears to have similar directional effects to those intended by risk-based entity regulation, but three points can be noted:

- Insurers appear to be able to make their assessments for more difficult cases much faster than regulators. We heard a number of complaints about insurance rates, particularly run-off insurance rates, but didn't hear complaints about undue delay in receiving insurance offers and decisions (unlike in relation to SRA processes).⁶⁸
- Insurers manifestly have stronger incentives to get their risk assessments right than do regulators: they have more at stake.
- Given that entity regulation assessments are additive to insurance assessments, the question of what precisely is added in terms of benefit remains. The interviewees tended to suggest that what was added was delay, uncertainty and cost, at least in less standard cases.

In the absence of positive answers to the outstanding question, our findings point toward a conclusion that the duplication of risk assessment leads to disproportionality in the costs imposed on innovation and adaptation in the way businesses are run. There is double cost to innovation: higher insurance premiums and more burdensome regulation. If the former are proportionate to the risks involved, by implication the combination of the two tends to be disproportionate.

Although it is less directly relevant to the barriers to entry, exit and mobility issues with which this report is concerned, it is also relevant to note, for the sake of completeness, that there is a more general issue of unnecessary duplication of effort which arises from the way that outcomes- focused regulation is applied to small practices. As discussed earlier, this requires each of a large number of small businesses to allocate resources to thinking through what compliance requires for them, in circumstances where the relevant objectives are broad, vague (what precisely is meant by the public interest?) and entangled, and where the links between (a) their own conduct and (b) the outcomes that a regulator might decide are consistent with its LSA objectives may be rather difficult to pin down.

Practices have, in effect, to try to assess (and guess is probably a more accurate description in many cases) what view the SRA will take on the implications of a particular piece of commercial conduct for (the SRA's) regulatory objectives, and in particular whether the conduct is compliant because the 'outcomes' help promote the objectives. Given this, it is natural for practices to seek assistance from the SRA when facing awkward questions about compliance (since it is the SRA that decides on the links between conduct, risks and outcomes, and that therefore decides whether conduct is compliant). Practices report that the SRA tends to be reluctant to give specific advice, on the

⁶⁸ The mandatory insurance renewal date has in the past clearly caused problems, about which some interviewees complained, but the very fact that such a restrictive system could be made to work at all points to the ability of insurers to produce quotes against tight deadlines.

ground that the point of outcomes-focused regulation is that it is up to firms themselves to make the assessment.

What is missing here is any sense of an efficient division of labour. It is a normal task of regulators to work back from rather general public policy objectives to narrower and more specific requirements that, if complied with, will have the desired effects overall. This reduces the costs of both compliance and enforcement and, if the overall regulatory system is well designed, it will promote the general objectives.

The principles involved in this exercise are not different from those of division of labour in the market or in a well-run organisation: each contributor has narrow and specific tasks and objectives, and is focused on those, not on market or organisational outcomes. Thus, if an employee encounters a particular problem and seeks advice, it will not be of much practical help to be told “do what is best for the organisational interest”. Similarly, it is not much help for a practice to be told to “do what is in the public interest”, particularly when the advice sought is from the body whose responsibility it is to define what the (highly vague) term ‘the public interest’ means in a particular context. This may explain a common view among interviewees who had approached the SRA for help that they had been disappointed in how little help they had received – a view that was accompanied in some cases by disillusionment that their ‘frontline’ SRA contact was not in touch with what ‘real world’ solicitors really needed to help comply with regulation.

For reasons discussed, the burden of compliance with regulations can be a particularly difficult problem for small firms, since it often draws limited, key resources from the main business of the firm (serving their customers) to deal with regulatory issues. The most usual way of handling this problem is to lighten the regulatory burden on such firms or, where that would lead to unacceptable levels of risk (e.g. in certain areas of environmental and safety regulation, such as the handling of dangerous substances), to write simple, clear, prescriptive rules, thus avoiding the costly duplication (and risks and uncertainties) of asking large numbers of businesses to work it out for themselves.

9. ALTERNATIVES

9.1. Introduction and framework for assessing alternatives

We have considered alternatives to those parts of the current regulations that appear most problematic, in response to the project specification requirements to:

- *“assess alternative options to meet the intended aims and assess their efficacy and their cost/benefits”, and*
- *consider any additional measures, whether regulatory or from the Law Society or Government, that could be introduced to enhance market operation.”*

The challenge is to ensure that the regulation and instruments that the SRA uses to achieve the desired LSA objectives are effective and efficient. That is to say, the regulatory requirements should address the problems they were developed to resolve and should minimise the costs involved, whether the direct compliance and enforcement costs of the regulated firms and the SRA itself or the more indirect costs that may arise because of impacts of regulation on the effectiveness with which the market functions. We emphasise again that most costs can be expected to find their way back to consumers in the end.

In order to consider potential alternatives it is necessary to anchor these in the objective or objectives that the relevant regulation or set of regulations is designed to achieve. Intuitively, this exercise may seem straightforward but, as already indicated, on closer examination it presents challenges. First, the underlying objective behind a particular regulatory requirement may not be stated or readily apparent at all. Second, where the broad objective can be identified it may be unclear in its definition, such as regulation founded on some general notion of the ‘public interest’. Third, there are a series of challenges or tensions stemming from recent legislative reforms and changes in the marketplace, which remains in a state of flux. For example:

- the desirability of consistent and neutral regulation of traditional and newer business models such as ABSs, but the difficulty in doing so in a context where intensity of regulation is based on perceived risks which are almost inevitably higher for newer, innovative and less familiar business models;
- the new role of outcomes-focused regulation in a profession that has historically focused more on black-letter rules;
- the diversity of the profession which ranges from the smaller practices (sole practitioners and sub-10 partners) to the larger City firms;
- the desirability of encouraging a more commercial approach to management of businesses in a profession which still bears elements of traditionalism (or, as one interviewee put it, has been *“slower to smell the coffee”* than much of the rest of society);

- there are costs to regulatory change, which add to regulatory burdens and which should also be taken into account, particularly in circumstances where practitioners and regulators are still adjusting to the major reforms introduced by and consequent to the LSA.

9.2. Views on alternatives

9.2.1. The overall position

With the exception of issues surrounding insurance, no very *specific, individual* problem of major significance was consistently identified across our three sources of information, based respectively on desk research, interviews and supplementary surveys.

In the course of our interviews, we invited interviewees to tell us if they had major concerns or suggestions for reform. We found that there was no single issue or issues that were marked out as real problems in need of fixing, which is not to say that interviewees reported unequivocal support for the regulatory framework: there were many quibbles.

Some interviewees had very specific thoughts on aspects that they would like to change and we summarise these in Annex 5 for the record: they may or may not correlate with findings of other research and of regulatory investigations. The suggestions range from options that tinker at the edges of current regulatory arrangements, to suggestions with much wider scope.⁶⁹ We have not examined such options in detail in this study, instead focusing on what we believe to be the core issues, which concern the effects on barriers to entry, exit and mobility of certain features of the regulatory regime and its enforcement, not of individual regulations.

For example, where we identified or had drawn to our attention specific barriers, we found that they were often not unique to solicitors, taxation being a case in point.⁷⁰ Often the issues identified affected a wider category of professional services firms operating on the basis of similar business structures to solicitors (e.g. LLPs, sole traders or partnerships). The comment of one professional tax planning advisor sums up the overriding theme of our interviews that there was no solicitor-specific taxation rule that operates as a material barrier or cost: “*Fundamentally, legal practice does not raise more difficult issues from a tax perspective than other professional services firms. That is not to say that the tax system applying to professional services firms could not be improved*”.⁷¹

9.2.2. Possible responses to general issue 1: insurance

Our investigations support the conclusion that current insurance arrangements are a source of barriers to entry, exit and mobility. However, since entry, (gross) exit and mobility rates are reasonably high, the magnitude of the barriers created does not appear to be particularly high.

⁶⁹ It should be clear from earlier sections that we find no fault in idiosyncrasy.

⁷⁰ We understand that the inability to set-off run off cover against income tax may be an added cost to exit decisions. However, we observe that the inability to claim tax relief for a cost that is not determined to be directly referable to an income stream is not unique to solicitors.

⁷¹ We note that the issue of wider reform to the taxation system is a subject beyond this study and on which the Law Society conducts advocacy on behalf of the profession.

Whether the resulting barriers are sufficient to warrant significant change in existing arrangements is, therefore, a question that cannot be answered on the basis of the broad evidence available: rather finer evaluation of the costs and benefits would be required. It is, however, possible to outline one or two of the alternatives that could merit consideration in such an exercise:

- Particularly in the light of difficulties to be encountered in the insurance market – with insurers finding it difficult to operate profitably by offering SRA-compliant terms and conditions to large numbers of small companies, and with more than one insurance company finding itself in financial difficulties and having to withdraw its supplies – the authorisation requirements in regard to insurance might be softened. Alternative ways of doing this include:
 - Allowing firms to operate for longer periods without the mandated cover, subject to appropriate conditions, such as providing clear and unambiguous warnings to clients that the relevant firm provides a lower degree of protection. We are aware of at least one precedent for this more flexible approach in the case of the exit of Lemma.
 - Lowering the level of minimum cover required in order to achieve authorisation, with a regulator-approved, kite-marked alternative for those who want it (and which can be advertised to clients/customers).
- Lowering the level of mandatory cover for closed firms, so as to reduce the costs of run-off cover.

It is to be recognised that such measures reduce the degree of consumer protection from this particular source (i.e. insurance), but they also serve to reduce costs and to reduce barriers to entry, exit and mobility, which can be expected to lead to benefits to consumers via lower legal fees (although again we stress that the effects are unlikely to be large). In this context, it is worth noting that consumers may place different valuations on risk depending on the type of legal services they are buying. For example, the same consumer may want to be satisfied that her solicitor is insured when purchasing conveyancing services but may be much less concerned about insurance when purchasing will writing services. The relevant question is therefore not ‘will consumer protection be weakened?’ but rather ‘would consumers be better off having the option of paying less for less protection’.

There are reasons to think they would (although it is not possible to be definitive on the basis of the findings of the current study). First, as we have pointed out, professional indemnity insurance provides protection not only for consumers but also for the partners and colleagues of miscreants whose conduct leads to claims. To the extent that all insurance costs raise fees, consumers may be paying for this ‘extra comfort’ for those partners and colleagues, in circumstances where they do not wish to do so. Second, less insurance protection might be expected to increase the self-policing incentives within entities, so the decline in protection might be rather less than it would appear from the face of the relevant documentation.⁷² Third, softening insurance requirements can be

⁷² This is a moral hazard point. If the pocket of one partner is more exposed to mischief done by another, the result may be tighter monitoring of the conduct of colleagues.

expected to put small practices in a stronger bargaining position when negotiating with insurers, helping to keep costs (and ultimately fees to consumers) down.

9.2.3. Possible responses to general issue 2: ‘too much’ (*ex ante*) regulation of business structures, business models, finances and governance.

We have concluded that there is a general issue of potential over-regulation of entities on an *ex ante* basis (i.e. in anticipation of a specific problem or harm arising), at least where regulation is directed toward matters of business models and structures (rather than at conduct directly related to the practice of law). The point here is that, when the restrictive effects of such ‘commercial’ regulation are taken account, there appears to be a complete lack of empirical evidence to substantiate a claim that the effects of the regulation are beneficial or *a fortiori* that the regulatory rules in place serve to create greater net benefits than feasible alternatives.

The current approach is illustrated by the authorisation and practising requirements set out in Table 2 above, all of which are *ex ante* requirements that need to be met before a regulated firm is able to practise or that need to be maintained in order to remain in practice. However, part of the issue is related to the culture of regulation which appears to err on the side of caution or prevention. As one interviewee and consultant expressed it in relation to intervention: *“I am also concerned that SRA is applying a rather heavy hammer to crack a small nut... The issue is that many firms view SRA with suspicion, even if they know what the regulator actually does. They do not expect to get a sympathetic ear when they are in trouble and believe that SRA will visit them with draconian sanctions if they approach the regulator with problems”*. This suggests that finding alternatives to existing ways of doing this would ultimately depend on more than just changing some of the formal regulations.

The most immediate alternative to an *ex ante* outcomes-focused approach is an *ex post* harm-based approach, meaning that regulatory action takes place when there is some specific reason for concluding that, in a particular case, an entity has behaved in ways that have given rise to harm or to materially increased risk of harm.

The main argument for such a shift is that it is more proportionate to the scale of the issues, but we have also questioned the feasibility of a regulator being able to assess and continually supervise the business plans and business organisation of thousands of small companies. The case for an adjustment is clearest in relation to business and financial issues, but it may also exist in relation to legal matters. Solicitors as individuals have responsibilities towards clients, and whilst it is arguable that *ex ante* regulation of the entities in which they work serves to strengthen incentives in this regard, the obvious questions are by how much and at what cost? Again the concern is that consumers do not get value for money for the extra protections: what is lost in higher regulatory costs and more risk averse, less innovative businesses may well have a significantly higher value than the reduced risks consequent on *ex ante* regulation, particularly in circumstances where there is an absence of empirical evidence on the links between *ex ante* regulation and subsequent market performance.

An *ex post* approach is sometimes characterised as ‘locking the stable door after the horse has bolted’, but this neglects its effect on incentives. Thus, the prospect of adverse consequences for practitioners of behaviour that causes harm, or that significantly increases the risk of harm, in the

form of sanctions applied, serves to deter the unwanted behaviour in the first place. And this is how things are done in a large number of other regulatory contexts, including competition law.

It is also possible to combine *ex ante* and *ex post* approaches to varying degrees, implying that there is a range of alternatives to the *status quo* that could move the system to a less intrusive approach. To give just one example, the requirement for an application for authorisation could be maintained, with new entrants required to provide information that included business plans and the like; but authorisation could be automatic unless the SRA found reasonable grounds for suspecting that entry would give rise to immediate and material risks for clients of the firm. If no such finding is made within, say, a six week period the firm could be deemed to have been authorised, or, if insurance requirements are to be maintained, it could be deemed authorised contingent only on it securing the necessary insurance. In effect, this would create a less restrictive ‘default position’.

A starting point for breaking away from the ‘regulate first’ approach is to focus on the fact that we are concerned with professional regulation. Notwithstanding that the SRA has identified over 40 sub-categories of risk, a consistent theme coming out of our interviews is that “*there are two main risks: fraud and negligence.*” It is notable here that both regulated firms and insurers were aligned in their views as to nature of the causes of ‘harm’, which correspond to these two broad types of conduct.

Viewed in this way, there is an argument in favour of a shift in emphasis toward (or a renewed focus on) the conduct of individual practitioners, rather than the ‘entity-based’ approach that characterises the authorisation procedure and parts of the Handbook. It should be noted that this option does not require legislative change or an amendment to existing regulations, at least in the initial stages. Rather, it calls for a strengthening of the disciplinary procedures for fraud, misconduct and negligence. These ‘*ex post*’ interventions provide the first line of defence for consumers and underpin the reputation of the profession.

While in the short-run there could be a continuation of the existing regulatory super-structure, a shift in emphasis could pave the way for a relaxation in the volume and reach of the current *ex ante* regime over time. Such a development was in fact foreshadowed by one of our interviewees. While she could understand the current approach, she reflected that “*on the whole, I think the level of regulation is on the heavy side right now. That should change (reduce) over time.*”

9.2.4. Possible responses to general issue 3: Poorly targeted regulation

We have concluded that there is some poor targeting in parts of the regulations. In particular the LSA (and SRA) objectives refer to the protection and promotion of consumer interests, whereas the regulatory system seems to be focused on protection of consumers *only against certain types of performance failures*. This risk reduction is not necessarily in consumers’ interests, and does not necessarily promote their interests. It is, we conjecture, based on an economic error that higher quality of service is always in the consumer interest. Whilst that might be true if other things were held equal, what it misses is the link between quality and costs and prices/fees. Higher quality of service might be obtained by pushing fees to excessive levels, or it might be achieved at the cost of chilling adaptation and innovation, to the detriment of consumer interests in the longer term.

Our recommendation is that outcomes-focused regulation itself be re-focused to give a significant role to the concept of value-for-money, which encompasses not only the quality and integrity of the services provided to or (in the case of regulation) on behalf of consumers, but also what consumers have to pay for those services. Since a well-functioning competitive market can be expected to provide customers with value for money this ‘outcome’ fits naturally with the LSA objective of promoting competition, as well as with the consumer objective set out in the LSA. Similarly, effective regulation should deliver value for money in the sense that the benefits it provides should demonstrably be in excess of its costs.

For the avoidance of doubt, what we have in mind is not a regulatory interest in the fees charged by solicitors (the extreme manifestation of which is price control) but rather a recognition that, in assessing risks to consumers, regulation is not just about preventing things that might go wrong, it is also about not preventing things that might go right. That is, non-authorisation or over-regulation of innovative firms puts consumer welfare just at much at risk as authorisation of a firm that looks like a walking hazard to its future clients.

To provide an indication of what this might involve at a more detailed level, we suggest that consideration be given to re-writing mandatory outcome O(1.6) so that it is much more clearly and directly linked to the LSA consumer and competition objectives. For example, it might say simply that fee arrangements should be such as to provide value for money, with guidance being provided on what this means in operational terms.

Thus, in strict terms, a customer who receives value for money is one whose interests or welfare have been advanced by the transaction in question. Not receiving value for money means the customer has been harmed by the transaction, and the avoidance of consumer harm is precisely the high-level motivation for consumer protection in circumstances where the consumer has difficulty in assessing the quality of the services supplied. Since much of the SRA’s activity is justified in terms of doing things that reduce the risk of consumer harm, it is difficult to see why there is no mandatory ‘do no harm’ outcome in the rule-book.

9.2.5. Possible responses to general issue 4: Duplication

There are two problematic aspects of duplication that we have identified in our assessment:

- It is inefficient to have large numbers of small firms working out what they need to do to ensure that the SRA takes the view that they are compliant with regulations in areas where simple rules or guidance can be issued.
- The overlap between the assessments made by the SRA of business plans, business structures, financial arrangements and governance and similar assessments made by insurers in particular, but also by banks and other suppliers of capital such as private equity firms

In relation to the first of these, the most common policy approach is simple deregulation for small firms. An alternative is a basic, simplified and relatively prescriptive rule-book.

In general, and not just in the legal services sector, smaller firms struggle more with outcomes-focused regulation. They very often have a preference for being given clear parameters within which to operate; and, if such parameters are not provided, frequently adopt strategies such as

‘staying below the radar’ (by avoiding doing anything unusual, avoiding business expansion, and so on) or burying their heads in the sand and ignoring the requirements completely (which probably tends to have less damaging consequences for market performance than ‘staying below the radar’).⁷³

With limited management resources, which not only have to cover the primary activities of a solicitors’ practice, but also deal with the business side of things, organise training, and deal with regulatory matters, the costs in time and effort of what, in the institutional economics literature, is called ‘consummate compliance’ tend to be relatively high in relation to the revenues of a small business. Devoting time and effort to thinking how best to comply with uncertain regulations has its benefits, but it also has costs; and those costs are massively duplicated across a large number of businesses. To repeat, there are strong incentives for small firms to ‘stay below the radar’, including by not doing things out of the ordinary, like innovating.

Aspects of this problem lie behind the comments of one partner in a London firm who was sceptical whether the ‘halfway house’ of Indicative Behaviours really helped to encourage more creative approaches. He observed that *“although they are ‘Indicative’ they are so prescriptive that they foster a system where you think that conduct which is consistent with an IB is essentially what SRA wants to see. The impression is that any departure needs to be justified. I thought this was the opposite of what OFR was designed to achieve which is a move away from rigid ‘one size fits all’ approaches”*.

In these circumstances, there is a straightforward case for just telling firms – or specific categories of firms such as very small enterprises - what is expected of them, if anything (beyond solicitors’ professional responsibilities). Such guidance or rules as there might be could be light and directed towards issues of misconduct, fraud and negligence – backed up by a more resolute *ex post* threat of removal of practising certificates.

In addition, consideration could be given to publication of tried and successful ‘best practices’ or procedures by law firm peers. One solicitor confessed that he did *“not really know what anyone else is doing or what SRA thinks are best practices.”* While it is still early days in terms of outcomes-focused regulation, there is a clear case for a sharing of information in terms of the SRA’s views on this issue and what regulated firms find works for them.

Turning to the duplication of effort by the SRA and insurers (and banks and private equity providers), the obvious alternative is for the SRA to stand back when similar assessments are being made on a commercial basis, on the view that both belt and braces are not necessary.⁷⁴ The argument for such an approach is clear when insurance with a minimum set of terms and conditions is mandatory, but it is also strong when insurance is not mandatory.

⁷³ We speculate that the culture of practitioners may push them toward the more ‘correct’, but more damaging, of the two strategies. Staying below the radar implies taking account of the rules, but being very conservative so as not to attract regulatory attention, whereas the head in the sand strategy involves the less proper conduct of simply ignoring the rules.

⁷⁴ For example, the SRA might confine itself to those specific aspects of assessment that (a) are not likely to be covered by insurers and (b) can, taking account of all relevant effects and evidence, be expected to contribute to regulatory objectives.

What we have in mind here is a potential arrangement in which there is only one trigger for SRA engagement with business models, structures, and finances – a failure to obtain insurance. In a limited version of this arrangement, firms might then be given say three to six months to sort out their affairs, rather than the current 30 days, which we were told by a restructuring consultant was insufficient time in most cases to deal with the issues in an efficient way. In a stronger version of the arrangement, practices could operate indefinitely without insurance but would be subject to SRA monitoring for so long as they lacked insurance and their status would be flagged to customers.

With the addition of *ex post* sanctions that vary according to *ex ante* conduct, solicitors' practices would be incentivised to take out more protective insurance cover, but they would not be compelled to do so. Practices would therefore be able to make use of their own knowledge about the trade-offs that they face – which in aggregate can be expected to be far superior to the knowledge about such trade-offs available to the regulator (given that there are thousands of small firms) – so as to determine the most appropriate way forward in each of myriad, particular sets of circumstances.

10. FINAL COMMENTS

Given the nature of the tasks, we have set out conclusions throughout this report, although the major concentration occurs in sections 8 and 9 above.

We started out with a relatively narrow conception of what might be involved in assessing the impact of regulation on barriers to entry, exit and mobility in the market for solicitors' services, but became increasingly puzzled by the nature of the regulatory arrangements that have developed. Regulation of the profession has traditionally been focused on the conduct of individual solicitors (i.e. individual professionals) for fairly obvious reasons. The post-LSA arrangements have shifted the focus much more to business entities, and the rationale for that is less easy to understand. An obvious question is: why is the regulation of individual conduct not sufficient to achieve the desired policy purposes? We have found no convincing answer to that question.

The motivation for change was the Legal Services Act 2007, but, so far as we can see, this in itself did not mandate a shift to entity regulation, or to outcomes-focused regulation in its current form, or to principles-based regulation, or to risk-based regulation. These seem to be later, discretionary choices, and they have led to a heavy-handed regulatory structure for a profession subject to what continue to be potentially substantial sanctions for individual misconduct and negligence, operating in a market populated with a large number of suppliers, many of very small size, in an institutional framework that offers multiple additional consumer protections (general consumer law, the Compensation Fund, the Solicitors Indemnity Fund, the Solicitors Disciplinary Tribunal, the Legal Ombudsman and the existence of extensive professional indemnity insurance).

We conjecture that the current structure is heavily influenced by what appears to us to be a disjunction between the LSA objectives and the risk-based, outcomes-focused philosophy that has been adopted. What appears to have happened is that first the mandatory principles and then the mandatory outcomes have been defined in ways that are not at all closely linked to the LSA objectives. Given the focus of the project, we have identified the consumer and competition objectives of the LSA as being cases of lack of linkage, but they are not the only ones.

This matters because, when it comes to the use of risk-based assessment, the relevant risks pertain to outcomes; but if outcomes are not closely related to objectives, risk-based assessment will not actually be focused on risks to the achievement of the LSA objectives, which we take to have been the original purpose. Regulation then tends to be ill targeted and disproportionate, and, in relation to barriers to entry, exit and mobility, to be unduly restrictive of innovation.

The remaining puzzle is that, despite these points, the market has nevertheless shown a good deal of flexibility and adaptability in structural terms. We conjecture that two factors are relevant here. First, whatever the formal structure of regulation, it is often the case that regulatees can pick their way through such a system in ways that minimise its impact on their conduct. We have given 'staying below the radar' as one example of such a strategy, whilst noting that this is not without

cost, since it tends to require the regulatee to avoid doing things which would bring it to the attention of the regulator, which in turn may give rise to a disinclination to be innovative.

Second, structural change in the market, of which there has been a lot, may mask a lack of development in other aspects of business which are more directly related to the LSA objectives. The extent to which there has been progress in the adaptation of new technologies or in improving value for money for consumers was not the focus of our study, although some interviewees' comments suggested that there was still considerable scope for improvement.

In ending, we return to our starting point: the objectives of the Legal Services Act. It will be recalled that the SRA must, so far as is reasonably practicable, act in a way which is compatible with the regulatory objectives. Our findings lead to the conclusion that current regulations surrounding entry, exit and mergers of solicitors' practices take insufficient account of at least two of the LSA objectives: the promotion of competition in legal services and the protection and promotion of consumers' interests. In relation to the second of these objectives, whilst the regulations take full account of the interests of consumers in being provided with high quality services, they appear to have little regard for the obvious consumer interest in the prices that have to be paid for such services.⁷⁵

⁷⁵ As we were completing this report the SRA published a policy statement, *Training for tomorrow*. The opening words of its Foreword illustrate the point in mind: *"The individuals, businesses and other entities that the SRA regulates offer services that are of critical importance in upholding the rule of law; protecting the rights of individuals; ensuring the efficiency of commercial and financial transactions and underpinning the strength of UK professional services in the global marketplace. It is essential that these services are of the highest possible quality and this requires a strong and effective system of legal education and training."* The first sentence is unobjectionable; but the notion that services necessarily have to be of the highest possible quality tends to imply a restricted market (serving only those who can afford the highest quality service), contrary to the LSA objectives.

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GLOSSARY

ABS	Alternative Business Structure
ARP	Assigned Risk Pool
BSB	Bar Standards Board
CILEx	Chartered Institute of Legal Executives
COFA	Compliance Officer for Finance and Administration
COLP	Compliance Officer for Legal Practice
CPD	Continuing professional development
EIP	Extended Indemnity Period
EPP	Extended Policy Period
ICAEW	Institute of Chartered Accountants in England and Wales
LLP	Limited liability partnership
LSB	Legal Services Board
OFT	Office of Fair Trading
PCH	Practice Certificate Holder
PPF	Private Practice Firm
REL	Registered European Lawyer
RFL	Registered Foreign Lawyer
SIF	Solicitors Indemnity Fund
SRA	Solicitors Regulation Authority

LIST OF ANNEXES

Annex 1: Research sand methodology

Annex 2: List of characteristics of interviewees

Annex 3: Small scale surveys

Annex 4: Detailed survey questionnaires

Annex 5: Suggestions of interviewees for changes in regulations

Annex 6: Alternative business strategies among interviewees