

# Consultation response

## SRA: Outcomes-focused regulation (OFR): transforming the SRA's regulation of legal services

### Overview

1. **OFR must work for the whole market, including small firms – with whom individual consumers mostly deal – which often prefer a prescriptive approach. An engagement strategy for small firms will help them respond positively to the new regime.**
2. **OFR creates a 'new deal' for lawyers. However, greater freedoms must not become self-regulation and should be balanced with tough enforcement against those who abuse this trust. Consumers should be empowered to shape the behaviour of solicitors.**
3. **Guidance in the Handbook should be kept to a minimum; the SRA should not formally recognise guidance developed by representative bodies as this could create safe harbours and runs counter to independent regulation.**
4. **Risk assessment should consider the severity of impact and type of consumer, such as vulnerable clients, in addition to the numbers of consumers affected. The SRA should also explore how to enhance risk literacy among consumers.**
5. **Individual consumers are poorly placed to identify and manage risks, as they use solicitors rarely and lack information. The SRA should not transfer a greater burden of risk to consumers under OFR.**
6. **The proposed inclusion of mystery shopping within the supervisory toolbox is very welcome. It will provide an unedited version of what firms actually say to consumers, in a way that audits and complaints cannot replicate.**
7. **The SRA has a consumer education role, but it should look to other organisations which have regular contact with consumers to play their part. Effective disclosure rules are also needed.**
8. **The SRA's expanded analysis and research capacity is welcome. It must include direct dialogue with consumers to inform policy, and an understanding of behavioural economics.**
9. **The consultation poses some important questions in relation to authorising firms on an activity basis and ensuring ongoing competence of solicitors. We look forward to an active dialogue with the SRA on these issues.**

### The proposals

10. **The SRA is moving to a system of outcomes-focused regulation (OFR) which concentrates on making sure firms offer good standards of service to consumers, while allowing compliant firms more flexibility in how they operate. The proposed approach includes:**
  - **Working with firms to focus on acting in a principled manner to deliver good**

standards of service to clients, rather than compliance with detailed rules;

- A sophisticated desk-based research and analysis capacity to assess potential risks to the regulatory outcomes and support the delivery of targeted proactive regulatory action;
- An approach to authorisation that is risk and evidence based, making sure that legal services are delivered by principled and competent firms and individuals;
- An approach to supervision which encourages firms and individuals to tackle risks themselves, allowing the SRA to concentrate on those who cannot, or will not put things right;
- An approach to enforcement which creates a credible deterrent and is effective, fair and proportionate; and
- Concentrating the SRA's resources on dealing with those firms who pose a serious risk to the regulatory objectives, such as protecting and promoting the interests of consumers.

## The Panel's response

### Goals and vision for OFR

11. The Panel reiterates its support for the move towards OFR, signalled in our response to the SRA's January 2010 Paper. OFR is well suited to the solicitors' profession and should ensure that the objectives behind regulation – in particular, consumer protection – are fully embedded in the practices of solicitors.
12. Each of the elements of the SRA's proposed overall approach to OFR is welcome. Of particular note is the inclusion of a sophisticated desk-based research and analysis capacity to assess potential risks and an approach to enforcement that creates a credible deterrent. OFR creates unprecedented freedoms for solicitors,

which must be balanced by tough action against the minority who abuse these freedoms. Furthermore, while the Panel welcomes the flexibility afforded to firms, care should be taken to ensure that OFR is not delivered in such a way that it becomes self-regulation.

13. An emphasis on consumer protection is a thread that runs throughout the document, which the Panel welcomes. However, there is a tendency to see consumers as passive beneficiaries of regulation. For example the emphasis is on "enabling consumers to understand what they should expect from their legal services providers". Instead, the SRA has an opportunity to harness consumer power to spur solicitors to deliver the principles, for example by identifying firms with poor compliance histories so that consumers can punish them by voting with their feet. Therefore, empowering consumers to demand good quality legal services should be an additional high-level element of the SRA's OFR regime.
14. Solicitors serve a diverse range of clients, ranging from FTSE 100 companies to the most vulnerable of individuals. The Panel's principal focus is on the interests of those consumers who are less able to give voice to their own interests. For large part, these consumers are served by small firms. Experience in financial services shows that small firms have difficulty complying with principles-based regulation preferring to be told what to do on the basis of clear rules. In legal services, small firms account for a disproportionate volume of complaints. As individual consumers use legal services rarely and suffer from asymmetries of information, they are in particular need of a regulator to protect their interests. Therefore, it is critical for the SRA to design OFR with small firms in mind, support them during the implementation of OFR and to factor the increased risk posed by small firms to consumers in its risk profiling.

## The new regulatory experience for consumers

15. The commitment to make consumers the key beneficiaries of OFR is very welcome. The Handbook will provide a new framework of rights for consumers as well as a new set of obligations for solicitors – it is important this document works for both. As the Panel will set out when responding to the separate consultation on the content of the Handbook, the draft in its existing form does not succeed in this first aim.
16. As the consultation states, consumers will mostly interact with the Legal Ombudsman, with only limited contact with the SRA. Communication about the SRA's relevant powers, and clear signposting to the Legal Ombudsman, will be important to help consumers navigate the regulatory landscape. There will be value in the SRA maintaining a contact centre to hear about problems needing action – for example, consumers wanting to report malpractice, although unable to pursue redress as they have not lost out financially. There should be a facility for consumers (and other potential whistleblowers) to report their suspicions. There are lessons from other sectors, for example Ofcom did not initially advertise its contact centre, but this has become a valued source of information.
17. Information provided by the Legal Ombudsman could lead to enforcement action. Information from the Legal Complaints Service shows that half its residential conveyancing caseload is accounted for by just two per cent of firms. Publicity of action to deal with this minority would promote confidence in regulation, as well as help to deal with the SRA's worry that consumers might perceive it is uninterested in their concerns.

## The new regulatory experience for firms

18. The Panel welcomes proposals to expand information collected from firms and to link this to the annual renewal process. Such information will assist in delivering regulatory outcomes, provided that compliance with certain requirements, such as recording first-tier complaints or completion of CPD hours, is a precondition of authorisation to practise.
19. Firms may complain about the burden this creates. However, good data can reduce burdens if it informs a risk-based approach. For example, information provided by the SRA about referral arrangements showed that a fraction of firms were over-reliant on a couple of introducers for work and so the independence of advice was not at risk.

## The Handbook - guidance

20. The Panel recommends the SRA focuses on formulating a clear Handbook so that the need for guidance is minimised. Some degree of uncertainty is healthy as the whole point of OFR is for firms to work out for themselves what behaviours would achieve the outcomes.
21. Should firms want further guidance, the profession or commercial bodies will meet this demand. However, the SRA should not give formal recognition to such guidance. Firstly, this could unnecessarily tie its hands and create 'safe harbours'. Secondly, the idea sits uncomfortably with the principle of separating representation and regulation functions that lies at the heart of the Legal Services Act. Thirdly, any such guidance would be drawn up without wider consultation – including with consumers – and thus at variance with the new open and transparent mode of regulation.

## OFR in operation – the Risk Centre

### Assessing risk

22. The consultation explains that the SRA is concerned to address risks that may:
- Impact on a significant number of consumers and/or third parties in a way that they cannot reasonably foresee or protect themselves from, and where this may lead to a loss of their money, justice, or social or economic wellbeing; and
  - Significantly impact on the public good that arises from the provision of competent and ethical legal services that also serve the higher public interest in the rule of law.
23. The number of consumers affected is a valid indicator of risk, but two other factors should be included:
- Severity of impact – considerable financial or other harm may result even if only a relatively small number of consumers are affected, but the consequences for individuals are serious, for example property fraud. Reports of such incidents could have wider reputational effects for the whole sector;
  - Types of consumer – some consumers, due to their personal circumstances, such as mental health problems, are less able to protect themselves. Therefore, where there are firms that are more likely to deal with vulnerable clients, this should be factored into the SRA's risk assessment.
24. Consideration of the impact on third parties, in addition to those individuals with whom the solicitor is contracted, is welcome. It is unclear to whom 'third parties' refers, but it might include home buyers losing out on a property due to the incompetence of the seller's solicitor.
25. The consultation indicates that the SRA will address risks that consumers 'cannot reasonably foresee'. While it is difficult to argue with this principle, the Panel would be deeply concerned if the SRA intended to transfer a greater degree of risk to consumers than exists presently. As individuals use legal services rarely, and because the law is specialised, it is very difficult for consumers to foresee risk, let alone protect themselves. It is unclear what risks the SRA thinks that individuals should reasonably foresee, or how it intends to measure this. The SRA should not move beyond the approach taken by the Legal Services Board in relation to ABS, which focuses on informing consumers about the risks (see outcome 16 in its guidance<sup>1</sup>).
26. In addition to protecting consumers from risks they cannot reasonably foresee, the SRA should also explore how to enhance consumers' risk literacy – in essence, how the public understand and manage the risks they face – and the SRA's own capacity for risk communication. This could have a beneficial impact on access to justice, for example it is probable that consumers underestimate the likelihood of having a legal problem in the same way that people underestimate the likelihood of illness. In healthcare, effective strategies have been developed to overcome such barriers.
27. The SRA needs to identify systemic risks, in addition to risks posed by individual firms, joining up the dots to see the bigger picture. This was a key lesson for regulators from the financial crisis, as the government has acknowledged in its proposed heightened scrutiny by the Bank of England.

## Intelligence

28. The intention to use information from a wide range of sources is welcome, including the advice sector (such as CABx), commercial operators (such as Panel Managers), and public bodies (such as the Legal Services Commission). There should be routine information flows between regulators. The Panel has previously highlighted a flaw whereby the Commission does not inform the SRA of solicitors who lose their legal aid contracts after failing peer reviews.
29. The legal profession is highly networked which means solicitors may know about misconduct by their fellow professionals, but equally be reluctant to pass on such information to the SRA. Effective whistle-blowing could provide a valuable source of intelligence. Furthermore, the SRA should consider building on its regulatory settlement agreements policy via a leniency regime for individuals or firms who alert it to misconduct by others in which they are also involved. The experience of the competition authorities would provide useful learning.

## Annual risk outlook

30. The proposal to publish an annual outlook of emerging risks and key areas of focus for firms is excellent. It will focus the minds of stakeholders and firms on the key issues facing the sector and the transparency should improve public confidence (as long as communication of the risks is effective) and enhance the SRA's accountability. The Panel hopes there is opportunity to feed information into this report.

## Authorisation

31. Under the Legal Services Act, the SRA will authorise ABSs on an activity basis. As the consultation notes, this raises a more fundamental question of whether over time

the SRA should move to authorise non-ABS solicitors on an activity basis.

32. Clearly, these are deep waters. The Panel has not formed its view on the issue and welcomes the SRA's intention to consult at a later time. There is merit in this approach, the key consumer benefit being that solicitors could only practise in areas in which they could demonstrate competence. Academic research suggests that consumers obtain better quality advice from 'specialised' lawyers<sup>2</sup>. However, there are risks to manage, such as dampening competition by creating unnecessary barriers to entry.
33. The authorisation regime should not be so onerous that it unreasonably discourages applications from new firms. The SRA should commit itself to targets for processing applications from new firms in a timely way.

## Supervisory approach

34. The SRA proposes that supervision will be tailored, taking into account the risk posed by the firm, size of firm and the firm's approach to risk management. Other factors should include the area of law and type of consumer, as retail consumers are far less able than corporate clients to identify and manage risk. Equally, a firm's business model should also influence the level of supervision, for example a firm that 'puts all its eggs in one basket', for example by specialising in an area of law susceptible to macro-economic developments (such as conveyancing depending on the housing market) or one that relies on referrals from one source for a high proportion of its income, should be subject to a greater degree of supervision. In short, the SRA should avoid a one-size-fits-all system, but instead ensure that its regulatory approach is suited to the diverse market.

35. The SRA rightly identifies the need to address the danger of regulatory capture. However, the consultation fails to say how the SRA intends to deal with this.
36. The proposal to visit firms on a risk-based assessment is supported. If the SRA's Risk Centre is effective, visiting all firms at least once over, say, five years would not be necessary. However, the SRA's supervisory approach should contain a random inspection element, especially as not all risks will be visible, for example complaints can only provide limited information given that consumers can rarely assess the quality of advice. The level of inspection activity will also depend on the SRA's wider framework for assessing quality. Clearly, if the competence of all lawyers was regularly assessed, the need for the SRA to inspect all lawyers periodically would be reduced.
37. The Panel welcomes the initial supervisory tools that the SRA intends using. The inclusion of mystery shopping is particularly pleasing. Consumers are poorly placed to identify malpractice, so mystery shopping helps regulators to find out what is happening in the marketplace. Mystery shopping is sometimes criticised as entrapment; however, it is a well-established research technique that is successfully used by other regulators, including the Financial Services Authority. While visits to firms capture formal documentation, they do not provide the unedited version of what firms actually say to clients in a 'real life' situation. Furthermore, the SRA should commit to publishing the results of mystery shopping exercises, which would provide a strong reputational incentive for solicitors to comply with the Handbook.

## Enforcement strategy

38. Effective enforcement will be critical to the success of OFR. The Panel supports the focus on education of well-intentioned firms to achieve compliance, while at the same time providing a credible deterrence. Our response to the January consultation emphasised the need for sanctions to bite on individuals as well as firms - the Panel is pleased to note this is part of the strategy.
39. The proposal to publicise enforcement action on priority issues to improve standards is welcome. In addition to seeking publicity on some issues, details of all concluded enforcement action should continue to be published. This is an essential part of creating a credible deterrence, maintaining public confidence in regulation and providing a predictable environment in which legitimate firms can know what is acceptable behaviour.
40. The proposed factors to be taken into account in deciding on enforcement action cover the right areas. The Panel is particularly pleased to see the emphasis on the impact on clients (as well as the number of clients) and whether the behaviour could have affected a vulnerable person or child.

## Consumer education

41. It is clearly important for consumers to have a good understanding of what to expect from their solicitor and what they need to guard against. However, as consumers rarely use legal services, it is difficult to know where to go for advice or to learn from previous experience. Awareness of the SRA will be low, so the majority of consumers will not visit its website. Therefore, the SRA should seek to use sources where consumers already turn for help, such as Consumer Direct. Comparison websites are starting to emerge in legal services and may provide

educational materials to add value to their core activity of helping consumers search for lawyers.

42. In the Panel's experience, consumers seek information when they need to know it, while educational messages aimed at everyone will often be forgotten before they need to be used. Therefore, while there is a role for educational materials, disclosure rules – that is, requiring solicitors to provide information to potential and existing clients – will be more successful in alerting consumers to their rights. It is vital to enforce such requirements, as experience with referral fees has shown<sup>3</sup>.
43. The SRA should exploit opportunities to publish information about the compliance record of firms. The SRA already publishes a good deal of information on regulatory decisions about individual practitioners, but there is an opportunity to do more. In particular, the SRA will be expected to collect data on first-tier complaints, which would provide valuable information about the extent to which firms are achieving OFR. The SRA should publish this information, mirroring the Financial Services Authority, which requires firms to publish information on how they handle complaints and which will publish its first set of consolidated data in September 2010.

### Education and training

44. The Panel welcomes the SRA's intention to look again at pre- and post-qualification requirements. The emphasis of professional regulation has been on entry requirements, but these may be insufficient on their own as an assurance of quality. The legal sector will undergo significant change over the next decade, while the substantive law changes regularly, as do client expectations. Therefore, putting in place effective mechanisms to ensure solicitors' ongoing competence is vitally important.

45. A close examination of the CPD system is needed to determine whether improvements are needed. The Panel's initial view is that more far-reaching measures, such as peer review or revalidation, might be required. Some solicitors are already subject to periodic reviews of competence, for example peer review of those holding legal aid contracts and various accreditation schemes. These are big issues to which the Panel will return.

### Evidence-based decision-making and research

46. The Panel is delighted by the commitment to expand the SRA's analysis and research capacity radically. All the proposed activities are worthwhile, but engaging consumers in the development of policy is a surprising omission. It will be impossible for the SRA to comprehend the economic impact of a new regulatory policy without seeking to understand how consumers are likely to respond to the change. Engaging in direct dialogue with consumers will help the SRA make better decisions and improve its accountability. The Consumer Panel hosted a workshop for Approved Regulators on this subject in July, to which the SRA contributed.
47. In addition to consumer engagement, the SRA should also develop its understanding of behavioural economics. Whereas economic textbooks see consumers as rational actors making choices based on fully informed decisions, behavioural economics combines psychology and the laws of economics to understand the factors that shape and affect behaviour.
48. The Panel welcomes the proposal to develop and publish measures of the SRA's success as a regulator, which focus on how its regulatory activities are improving firms' delivery of the principles and outcomes.

Over the course of 2010-11, the Panel is developing a Consumer Welfare Index to help judge the impact of the whole gamut of regulatory reforms on outcomes for consumers. The Panel's exercise will have some parallels with the SRA's and we look forward to sharing thinking in this area.

### SRA – people, culture and systems

49. The SRA should consider mechanisms through which a consumer focus should infuse its people, culture and systems, including staff secondments to consumer bodies and audits of its systems against consumer-facing criteria, such as those developed by the Communication Consumer Panel's Toolkit<sup>4</sup> and Consumer Focus's Rating Regulators report<sup>5</sup>.

## July 2010

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<sup>1</sup> Legal Services Board, *Alternative business structures: approaches to licensing. Guidance to licensing authorities on the content of licensing rules*, 2010.

<sup>2</sup> Richard Moorhead, *Lawyer Specialisation – Managing the Professional Paradox*, Cardiff Law School Research Papers No: 5, 2008.

<sup>3</sup> Legal Services Consumer Panel, *Referral Arrangements*, 2010.

<sup>4</sup> Communications Consumer Panel, *Capturing the consumer interest: A toolkit for regulators and government*, 2006.

<sup>5</sup> Consumer Focus, *Rating Regulators*, 2009.