EXPLANATORY MEMORANDUM TO

THE LEGAL SERVICES ACT 2007 (FUNCTIONS OF A DESIGNATED REGULATOR) ORDER 2008

2008 No. Draft

1. This explanatory memorandum has been prepared by the Ministry of Justice and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 The instrument amends the new section 9A to be inserted into the Administration of Justice Act 1985 ("the 1985 Act") by paragraph 82 of Schedule 16 to the Legal Services Act 2007 ("the 2007 Act").

2.2 It is made under paragraph 2 of Schedule 22 to the 2007 Act, which permits the Lord Chancellor to modify or make any other provisions relating to the functions of designated regulators or other bodies by order and has been made following a recommendation by the Law Society under paragraph 2(4)(a) of that Schedule.

2.3 The amendment modifies section 9A of the 1985 Act to remove a restriction that would prevent legal practices from having multiple corporate tiers.

2.4 Specifically, it:

2.4.1 removes the requirement in 9A(5) for legally qualified persons to be individuals for the purpose of the satisfaction of the management and control condition;

2.4.2 recognises law firms existing at the point of commencement of the order which continue to satisfy the Law Society's relevant pre-commencement conduct rules as "legally qualified";

2.4.3 recognises bodies corporate recognised under section 9 at the point in which 9A is commenced and which continue to satisfy the Law Society's relevant pre-commencement conduct rules as "legally qualified"; and

2.4.4 The order also permits the Law Society to make rules prescribing a new category of what it is to be legally qualified by reference to management and control criteria.

2.5 Bodies which are legally qualified must satisfy all of the other conditions in section 9A in order to be "legal services bodies". The Law Society's rules will be published in draft and will be the subject of separate consultation. Additionally, further safeguards are provided through the

statutory requirement for the rules to approved, either under Schedule 4 of the Courts and Legal Services Act, or under the Legal Services Act 2007.

2.6 Finally, the order sets out a number of definitions relating to legal partnerships, managers, solicitors etc for the purposes of the provision.

3. Matters of special interest to the Joint Committee on Statutory Instrument

3.1 The order makes a textual amendment to primary legislation and we confirm that the approval of Parliamentary Counsel has been given.

4. Legislative Context

4.1 This instrument amends provisions of the 2007 Act which received Royal Assent on 30 October 2007. To date, two commencement orders have been made under sections 211 and 208 of the 2007 Act in respect of the Legal Services Board, Office for Legal Complaints and legislation relating to regulatory bodies.

4.2 The order is needed in order to facilitate the effective operation of the regulatory powers of the Law Society specifically those under sections 9 and 9A of the 1985 Act (under which the Law Society recognises bodies as suitable to provide legal services). These changes are necessary before the commencement of paragraphs 81 and 82 of Schedule 16 which amend section 9 of, and insert section 9A into, the 1985 Act.

5. Territorial Extent and Application

5.1 This instrument applies to England and Wales

6. European Convention on Human Rights

The Parliamentary Under Secretary of State, Bridget Prentice, has made the following statement regarding Human Rights:

In my view the provisions of the Legal Services Act 2007 (Functions of a Designated Regulator) Order 2008 are compatible with the Convention rights.

7. Policy background

- ***What is being done and why***

7.1 The 2007 Act reforms the way in which legal services are regulated in England & Wales. The aims of the Act are to simplify the existing regulatory framework by establishing an oversight regulator, the Legal Services Board ("the LSB") and improving consumer confidence and the way in which complaints are dealt with by establishing an independent complaints handling body; the Office for Legal Complaints ("the OLC").

7.2 The 2007 Act also provides greater choice and flexibility for consumers, and more innovative and efficient organisation of legal practices by providing for alternative business structures ("ABS"). The ABS framework set out in Part 5 of the 2007 Act permits different kinds of lawyers and non-lawyers to work together, and allows for external investment. This will be subject to a licensing regime set out by the LSB.

7.3 During the Parliamentary passage of the 2007 Act, strong calls were made to allow for a limited form of ABS in advance of full implementation, in the form of Legal Disciplinary Practices (LDPs). LDPs allow different types of lawyer to work together, offering a variety of legal services, and also allows a limited number of non-lawyers into the management and ownership structures. However, in advance of the full ABS licensing regime, these bodies will be restricted in ownership to ensure that they are low risk: a management and control condition, and lawyer and services conditions limits the number of non-lawyers (a maximum of 25%) to ensure that LDPs are still majority owned and managed by lawyers, and ensure that those firms continue to provide legal services.

7.4 LDPs are dealt with under an amended section 9 of the 1985 Act which currently deals with incorporated practices. Paragraph 81 of the 2007 Act extends section 9 of the 1985 Act to refer to legal services bodies (which will include partnerships). In turn, paragraph 82 of the 2007 Act inserts a new section 9A of the 1985 Act which defines legal services bodies as bodies which satisfy a management and control condition requiring a minimum level of legally qualified ownership or management, and a relevant lawyer condition where at least one manager is a solicitor, registered European lawyer or qualifying body. Section 9A then defines what it is to be "legally qualified", which includes individuals who are authorised persons, registered foreign lawyers, and limited forms of bodies.

7.5 As drafted, section 9A limits the definition of legally qualified to bodies comprising individuals who are authorised persons, or bodies which comprise entirely individuals who are authorised persons. Under the existing section 9 of the 1985 Act, the Law Society currently permits bodies whose ownership structures include corporate tiers. Section 9A, as drafted, would therefore preclude these existing structures from being regarded as legally qualified.

7.6 This presents a discrepancy over the ability of certain bodies to be eligible to become legal services bodies, with some qualifying automatically under section 9A as it stands, and others who would have to restructure, at possibly considerable expense, in order to comply with the model prescribed in section 9A despite being permitted under the existing section 9 of the 1985 Act. Other additional benefits of structural organisation, such as more efficient transfer of ownership under the movement of partners to and from the organisation would be lost through the need to restructure. Furthermore, any new bodies seeking to become legal services bodies would need to comply with the model prescribed in the existing 9A, thus preventing them from being able to enjoy the benefits of structures currently permitted.

7.7 The purpose of this order, therefore, is to amend section 9A so that those existing structures and the bodies prescribed by Law Society rules, are to be regarded as legally qualified for the purposes of 9A(6), and may be regarded as legal services bodies so long as they meet the section 9A conditions.

- ***Consolidation***

7.8 The amendments set out in the order relate to a new section 9A in the Administration of Justice Act 1985. That provision is not yet in force, and no consolidation is required as a result of the Order.

8. Consultation outcome

8.1 In accordance with the procedure set out in paragraphs 2 and 3 of Schedule 22 to the 2007 Act, the Law Society, being the designated regulator to which the order applies, has made a recommendation to the Lord Chancellor that an order be made to regulate its members more effectively.

8.2 The recommendation was accompanied by a draft order, which, in accordance with paragraph 3(2) was published by Lord Chancellor alongside a notice inviting representations about it within a specified period, ending on 17th October 2008. In accordance with paragraph 3(3), copies of the document were also given to the Lord Chief Justice and Office of Fair Trading, inviting them to provide advice within the period specified in the notice.

8.3 The Ministry of Justice had given notification of the recommendation and draft order to stakeholders (including other regulators and consumer organisations) in advance of the formal notice in order to assist them.

8.4 Responses were received from nine organisations, including the Lord Chief Justice and the Office of Fair Trading, as well as other members of the legal profession. All supported the order, with the Office of Fair Trading concluding that the Order would not have, or be likely to have the effect of restricting, distorting or preventing competition within the market for reserved legal services to any significant extent.

8.5 During the consultation period, a number of minor amendments were made to the definition of legally partnership and to make footnote reference to relevant legislation. Under paragraph 3(7), if the order which the Lord Chancellor proposes to make differs from the draft order published, he must publish the draft order alongside a statement detailing the changes made. The amended order and accompanying statement have been published on the Ministry of Justice website.

9. Guidance

9.1 The instrument relates to an order which amends the regulatory powers of the Law Society. As the Society recommended the order under Schedule 22

of the Legal Services Act, no further guidance is needed as to the operation of the provisions within the instrument.

10. Impact

10.1 A full regulatory impact assessment was prepared for the Legal Services Bill in November 2006, and a supplementary memorandum was published in June 2007. The full RIA can be found at http://www.dca.gov.uk/risk/ria-legal-services.pdf and the supplementary memorandum can be found at http://www.justice.gov.uk/docs/RIA-Supplement-v021.pdf . The full RIA includes sections which examine the options considered and our reasoning for the final recommendations which were brought forward in the 2007 Act.

10.2 A separate impact assessment has not been prepared for this order. However, the regulatory impact of enabling LDPs is specifically considered in Part 5 (including an assessment of both full ABS and of LDPs) of the full RIA, as referred to in paragraph 10.1 above. The relevant extract is attached at Annex A.

11. Regulating small business

11.1 The legislation applies to small business.

11.2 To minimise the impact of the requirements on firms employing up to 20 people, the approach taken is as set out in paragraph 2.4 above, allowing firms already recognised by the Law Society under section 9 of the Administration of Justice Act to continue to be so recognised, and to permit the Law Society to define by rules other bodies that may be so recognised. As the representative body for law firms and practices, the Law Society was consulted fully on the instrument (see paragraph 8.1 above).

12. Monitoring & review

12.1 The Lord Chancellor will be responsible for approving the Law Society's rules as set out in paragraph 2.5 above. The approval process will require further consultation and advice, ensuring that the LDP provisions are examined in detail before they come into force.

12.2 Furthermore, Part 5 of the 2007 Act provides for full alternative business structures - bodies which may include unlimited numbers of non-lawyers - regulated under the licensing regime set out in that part of the Act. The provisions relating to LDPs will therefore be reviewed when Part 5 is commenced.

13. Contact

Kerri Phillips at the Ministry of Justice Tel: 020 7210 8397 or email: kerri.phillips@justice.gsi.gov.uk can answer any queries regarding the instrument.

Annex A

Extract from Chapter 5 of the Legal Services Bill
Full Regulatory Impact Assessment

Option 2 – Facilitate the formation of legal disciplinary practices (LDPs)

Benefits

Economic benefits

5.12. Enabling a wider range of business structures in legal services should benefit consumers and suppliers by allowing the legal services market to work better. This is because competition between existing suppliers, and potential competition from new suppliers and from new forms of supply, would be less restricted as a result of the removal of the current restrictions on partnerships between legal practitioners. In particular, allowing new capital from outside the legal service industry should increase capacity and exert a downward pressure on prices[29] via increased competition.

5.13. In addition, allowing the formation of LDPs would increase the scope of sharing the risks of starting a new firm among new entrants to the legal services market, leading to a decrease in financing costs. This would lower the barriers to entry for potential new entrants, potentially increasing the number of suppliers in the market, stimulating more competition and encouraging innovation, leading to an increase in the quality of the services.

5.14. Creating integrated legal practices would bring greater convenience to consumers by allowing a one-stop shop for different types of legal services e.g. car insurance and accident claim services. In addition, integrated legal practices would provide opportunities for LDPs to gain from economies of scale (economies of scope and/or economies of specialisation). If so, it is envisaged that the cost of these legal services would fall as consumers would now have the opportunity to purchase services from a single LDP, if they preferred, rather than having to purchase from a number of suppliers. The degree of the reduction in costs, however, would depend on the level of competition in the legal services market.

5.15. Allowing external investment in LDPs would give these firms access to a wider pool of capital, for example via share issue, that could be used for new investment such as upgrading infrastructure and greater innovation in the provision of legal services in more consumer-friendly ways. This should then generate scope for further efficiency gains.[30] Additionally, the increased access to external financing and the inherent flexibility of LDPs would give more opportunities for owners to invest in

[29] It has been noted that a combination of technology, regulatory changes and the removal of the ban on advertising have resulted in reductions in the prices of conveyancing services. See Stephen, F. H., Love, J. H. & Paterson, A. A., (November 1994), Deregulation of conveyancing markets in England and Wales, Fiscal Studies, 15, pp. 102-118

[30] It has been argued that permitting external financing of law firms would be key to the introduction of more information technology to reduce the costs of personal legal services that involve relatively small but numerous transactions of a similar nature, and that under the current rules similar transformation

expanding their businesses to take advantage of any changes in legal services market, and help to maintain or increase the international competitiveness of the UK legal service sector.[31]

5.16. External owners of LDPs might seek to float a stake in the stock market, which could then improve efficiency by sending a market signal concerning the future prospects of the firm. Prospective recruits and investors could find this valuable in choosing among alternative employers and investments, and the LDP could also find this useful for evaluating its own performance.[32]

5.17. In addition, the reduction of the need for partnership equity in LDPs would lower the barriers to entry for potential new entrants[33], potentially increasing the number of suppliers in the market, help stimulate greater competition and encourage innovation. It would also allow owners and partners of LDPs to diversify their risks, lowering the cost of capital, and facilitating their withdrawals from the legal services market by making their interests more liquid.[34]

5.18. External financiers of LDPs might want to build on the reputation of newly established LDPs by developing brands and by ensuring that the quality of services offered satisfy consumer demand.[35] Once a reputation had been established, an LDP would have a strong incentive to maintain the quality of service so that business would not be lost. As a result, its owners might demand stricter operational discipline such as a higher level of internal controls with checks and balances in connection with consumers' monies (in particular if the LDP becomes a public limited company) to protect the reputation, which could potentially lead to an increase in efficiency. This should also lessen the likelihood of harm done to consumers due to conflict of interests.[36]

Social benefits

5.19. We expect that innovations in the legal services market, driven by the expected increase in the level of competition in the market, could lead to the introduction of new customer service techniques and new channels for delivering services. As a

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would be unlikely to take place. See Dow, J and Lapuerta, C, (2005), The benefits of multiple ownership models in law services. [http://www.dca.gov.uk/legalsys/lsreform.htm#cr]

[31] It has been argued that the strong competitive position of English law firms is likely to be maintained only if the legal profession is adaptable. See Brealey, R A and Franks, J R, (2005), The organisational structure of legal firms; a discussion of the recommendations of the 2004 Review of the Regulatory Framework for Legal Services in England and Wales. [http://www.dca.gov.uk/legalsys/lsreform.htm#cr]

[32] See Dow, J and Lapuerta, C, (2005), op. cit.

[33] It has been suggested that the illiquidity of partnership equity places the law firm at some competitive disadvantage in recruiting. Brealey, R A and Franks, J R (2005). op. cit.

[34] Dow, J and Lapuerta, C, (2005) and Brealey, R A and Franks, J R, (2005), op. cit.

[35] Data provided by The Law Society, shows that claims of 'dishonest practice' are disproportionately generated by smaller law firms (as measured by number of partners) which tend to have less incentives to build up reputation compared to their larger counterparts. Grout, P A, (2005), The Clementi Report: Potential risks of external ownership and regulatory response – A report to the Department for Constitutional Affairs. [http://www.dca.gov.uk/legalsys/lsreform.htm#cr]

[36] Blanes i Vidal, Jordi, Ian Jewitt and Clare Leaver, 2005, Legal Disciplinary Practices: A Discussion of the Clementi

Proposals - http://www.dca.gov.uk/legalsys/blanes-i-vidal-leaver-jewitt.pdf

result, less mobile consumers and those living in rural areas could find it easier to purchase legal services, enhancing access to justice.

5.20. One example of how embracing new technologies and marketing ideas can benefit legal service providers and consumers alike is the model used by firms such as Shop4Law.[37] Shop4Law uses an internet-based programme through which consumers identify their personal needs and are matched with individual legal service providers. For solicitors, Shop4Law is an innovative way to promote themselves and develop their businesses in a cost effective way. For consumers, the website provides a convenient and user-friendly way of finding a solicitor who is most closely aligned to their preferences (be they location, experience, cost or speed of service).

5.21. The reduction of the need for partnership equity in LDPs is expected to provide more opportunities to a wider range of individuals, such as female legal professionals[38] and those from lower income groups[39] who might have the required competence but not the capital or time to progress within existing legal partnership arrangements. It should also make it easier for LDPs to hire and retain high-quality para-legal and managerial staff.

5.22. The potential increase in the number of suppliers in the legal services market could also potentially increase the number of training opportunities for law students, including those from under-represented groups. In particular, it has been pointed out that the increased flexibility provided by LDPs would improve the representation of women and their retention at the Bar.[40] This could also help to further increase diversity in the legal professions.

Costs

Economic costs

5.23. Although constrained by the existing regulatory framework, many in the legal profession have sought to extend the range of legal and non-legal services that they can deliver. For example, a number of legal practices currently offer financial services as part of an all-round service to their customers. Under this option, LDPs would be restricted to the provision of legal services only, which could be more restrictive than the current system where legal practices can offer a wide range of unregulated (non-legal) services such as general business advice and estate agency services, as well as other regulated services such as financial advice. This would reduce the incentives for prospective owners to establish a new LDP, reducing the potential scope of competition within the legal services market, to the detriment of consumers of legal services.

5.24. Concerns have been expressed that the introduction of outside ownership of LDPs may lead to the leaking of clients' confidential information protected from disclosure under legal professional privilege (LPP) due to unreasonable commercial pressure or conflicts of interest[41], thus compromising the interests of consumers.

[37] http://www.shop4law.co.uk/

[38] See 5.47

[39] Office of Fair Trading, (2001), op. cit.

[40] Blanes i Vidal, J, Jewitt, I and Leaver, C, (2005), op. cit

[41] It has been pointed out that conflicts of interests are the other side of the coin to synergies, and if most operations of the LDP were ring-fenced, then opportunities for synergies in the LDP would be

However, it has been argued that the potential harm from conflicts of interest caused to consumers is often induced by the inability of owners to perfectly control managers, rather than by their excessive ability to do so.[42] In addition, it is expected that the proposed safeguards in place, such as the fitness-to-own test and the incorporation of a HOLP and a HOFA in the LDP, would minimise this risk.[43] Furthermore, commercial considerations should also play an important role in protecting confidential information.

Social costs

5.25. There is a risk that the anticipated increase in the level of competition in the legal services market could lead to the withdrawal of some inefficient suppliers of legal services from certain areas of the market. In particular, inefficient suppliers on local high streets and in rural areas may be forced to close down under the pressure of greater competition from lower cost providers. This raises the potential risk of reducing consumer choices and could have an adverse effect on access to justice. This risk should be mitigated by the expected changes in the provision of legal services.

5.26. Different legal practitioners would have the opportunity to form integrated legal practices and be more efficient by taking advantage of the potential gains from economies of scale, thus ensuring that they could continue offering legal services (see para. 5.30). In addition, new innovations in the legal services market, driven by greater competition, could lead to new ways of legal services being delivered to consumers in rural areas, thus ensuring that their access to justice would not be diminished (see para. 5.46).

limited. The resulting gains from economies of scale are correspondingly lower. Brealey, R A & Franks, J R, (2005), op. cit.

[42] Blanes i Vidal, J, Jewitt, I and Leaver, C, (2005), op. cit

[43] It has been argued that conflicts of interest already exist in law firms and that the resulting problems would be better dealt with by regulation rather than by severe restrictions on outside ownership. See Brealey, R A &Franks, J R, (2005), op. cit.