



Financial protection arrangements

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Executive summary

Background

- 1.1. The Legal Services Board (LSB) asked for the Panel's advice on whether the regulators' financial protection regimes are adequate and the level of risk that consumers should bear.
- 1.2. The Legal Services Act 2007 requires the regulators to have appropriate insurance and compensation arrangements. Such financial protections are designed to protect consumers from identifiable financial loss due to dishonesty, fraud, negligence or failure to account.
- 1.3. The arrangements also benefit the profession, covering lawyers for civil liability claims and helping to maintain public confidence. But they come at a cost: data suggests that professional indemnity insurance is often the third highest cost for solicitors after staff payments and office overheads.
- 1.4. There have previously been reviews of financial protection arrangements and others are underway. The Panel has added value by approaching this subject from a resolutely consumer perspective. Our analysis should inform these current reviews and future rule change applications. We also consider this report provides a good case study for the LSB's new cost and complexity of regulation project.

Mapping the risks

- 1.5. The Panel mapped the current arrangements against the types of risk

consumers can face when using legal services. The main risks centre around:

- Theft of client money – for example a mortgage is not paid off;
 - Failure to account for client money – such as a shortfall appearing in a client account due to poor accounting;
 - Other dishonesty – perhaps a dishonest instrument being drawn up or theft of property such as jewellery when administering an estate;
 - Insolvency – if this happens the consumer may have problems getting in touch with the firm or accessing their papers. Fees paid in advance may be lost;
 - Negligence – for example a property may not be correctly registered in the buyer's name or a consumer does not receive the full settlement they should due to their lawyer's actions (or inactions);
 - Fraud – for instance the true purchase price or the borrower's true financial position is not disclosed to the lender, allowing them to take out a mortgage the lender may otherwise have been reluctant to agree.
- 1.6. Thematically, client accounts are considered a high risk, while residential and commercial property conveyancing, and wills, estate administration and probate are thought to be the highest risk areas of law.

Our assessment

- 1.7. The Panel developed indicators of successful financial protection arrangements and assessed the current arrangements against them. Our indicators drew from other sectors such as financial services, as well as broader consumer principles. The indicators are:
- Comprehensive coverage of risks;
 - Accessible to users;
 - Work efficiently for consumers, and disruption is minimised;
 - Transparency over the decision making process and performance;
 - Independent governance arrangements;
 - Information is shared between different organisations;
 - Risk-based; and
 - Cost-effective.
- 1.8. Assessment of the current arrangements has been challenging due to lack of available data. For example, there is little information about claims made or paid out, the decision-making criteria used to make discretionary awards or the time taken to process grant applications. One of our recommendations is for greater transparency so that the regimes can be more easily held to account.
- 1.9. Despite some challenges around access to data, at a high level, and on most occasions the financial protection regimes will deliver redress against each of the key risks that consumers face when buying legal services. They are designed to offer a comprehensive level of protection and assume that consumers should bear quite a low burden of risk – we consider this is entirely appropriate given the nature of legal services, consequences of the risks transpiring and the difficulty consumers face in preventing loss.
- 1.10. Looking at the regimes in detail, we have identified a series of issues, concerns and areas for improvement. These include scenarios where consumers may unfairly lose out due to gaps in coverage, disputed territory between regulators and insurers and issues related to the discretionary nature of schemes. In addition, the protections can be difficult to access, fragmented and lack transparency.
- 1.11. An overview of our concerns is set out in the table overleaf.

Table 1: Overview of concerns

Success criteria	Overview of concerns
Comprehensive risk coverage	<ul style="list-style-type: none"> • Caps on cover at different levels – inconsistencies hard to explain • Possible aggregation of claims by insurers risks artificial caps on claims • Insolvency risks presented by unrated insurance firms • Discretionary nature of compensation funds • Different approaches for special bodies
Accessibility	<ul style="list-style-type: none"> • Different routes to redress creates scope for confusion • Absence of research to test consumer experience of accessing schemes
Efficiency	<ul style="list-style-type: none"> • No performance data on timeliness published so impossible to assess
Transparency	<ul style="list-style-type: none"> • Lack of information on how claims are assessed given discretionary nature of compensation funds • Lack of claims data or performance reporting means poor accountability
Information sharing arrangements	<ul style="list-style-type: none"> • Reporting obligations in place but appear to be underused • Information shared may not be acted upon • Apparent lack of information sharing between different regulators • In some cases data protection rules may prevent information sharing
Risk-based	<ul style="list-style-type: none"> • Regimes currently based on professional title rather than activity/risk • Lack of risk-based premiums for compensation funds
Independence from profession	<ul style="list-style-type: none"> • Not reviewed, as assessed by LSB under Internal Governance Rules
Cost-effective	<ul style="list-style-type: none"> • Rising cost of interventions • Greater joining-up of arrangements may be more efficient – but this needs to be examined in greater detail

Alternative options

- 1.12. While the current regimes provide a comprehensive coverage of the risks, this comes at a high cost. Although our research shows that consumers greatly value the protections offered and are willing to pay for them, it is quite possible that the same level of protection could be delivered more cheaply if the system was organised differently. This report has explored three alternative options – inviting consumers to take out their own insurance, de-risking the system through a different approach to handling client money and establishing a single financial protection regime.
- 1.13. We firmly reject the option that consumers should be invited to take out their own insurance. Due to information asymmetries consumers are not well able to shop around and self-insure when choosing a lawyer, whilst due to their preconceptions about legal services being a regulated market they are unlikely to realise they should do so. Moreover, it is the lawyer who is the source of risk and as such they should be the party to seek insurance. There is also a risk that informed consumers will only use insured lawyers, while more vulnerable consumers will either not realise that mandatory protections are not in place, or will choose lawyers without insurance solely on the basis of cost.
- 1.14. It is encouraging that options to restrict the need for lawyers to hold client money are being explored, including the establishment of escrow schemes. While not eliminating all risk, and not suitable in every situation, escrow accounts offer a range of consumer benefits: the client's consent is needed to authorise payments, an ombudsman is available in case of dispute, it is backed by insurance and there is access to a compensation fund. Escrow accounts are also simple for providers to manage and offer savings compared to existing arrangements.
- 1.15. A more radical solution, but one which should be fully explored, is to join up arrangements across the sector, providing a single umbrella which sets minimum terms and conditions for insurance, as well as delivering a single compensation fund. This could have a number of advantages, including a single access point for consumers, potentially lower costs for lawyers (as administrative costs would no longer be duplicated), risk-based pricing unaffected by professional title, and a single point for data collection and analysis. Such an arrangement could also provide the possibility for unregulated providers to come under the scheme if they wanted to.

Recommendations

The Panel's advice to the LSB is as follows:

- Financial protections should remain mandatory.
- Consumers should not be asked to source their own insurance.
- Approved Regulators should be required to collect more comprehensive data on financial protections, especially in relation to compensation funds. Data should be published in an accessible and timely manner.
- A set of key performance indicators should be developed for compensation funds, and assessment should then be made against these.
- The discretionary nature of compensation funds should be examined in greater detail, and research should be carried out with consumers who have gone through the process of making a claim.
- The LSB should encourage greater openness and joined-up working between Approved Regulators, the Legal Ombudsman and other actors in the financial protection field:
 - This could include the introduction of formal processes for information sharing between Approved Regulators themselves (such processes are already in place between regulators and insurers, as well as between regulators and the Legal Ombudsman).
 - Existing information sharing channels should be used to better effect to improve intelligence gathering and any subsequent enforcement action .

This would help to stop problems before they reach the stage where financial protection measures are needed.

- As part of the LSB's work on general legal advice we recommend attention is paid to the financial protections in place (if any) for those using unregulated providers. In particular, the Panel is concerned about the potential detriment to consumers when protections are not in place, or not adequately enforced.
- Finally, we strongly recommend that the idea of centralised protection arrangements for all regulated legal advice providers is fully scoped, with attention paid also to the possibility of bringing unregulated providers (or those who currently have no financial protection arrangements) under the same umbrella.

2 Introduction

Introduction

- 2.1. Financial protection arrangements such as professional indemnity insurance and compensation funds are mechanisms which regulators use to protect clients from loss due to dishonesty, fraud, negligence, insolvency or failure to account. When this involves matters such as a house sale or dealing with an estate, huge sums of money and stress can potentially be involved. For example, a dishonest lawyer could simply disappear with a person's life savings. Therefore, financial protections offer important safeguards against catastrophic events.
- 2.2. The existence of these protections fits with public perceptions about levels of regulation in legal services. Understandably, due to their rare occurrence, consumers do not think about risks of fraud or insolvency when engaging a lawyer, but instead worry about risks of poor service such as delay and escalating fees. However, they do think in general terms that there are regulatory protections in place when using lawyers, even if they cannot specify what these actually are. Once told about financial protections, the public gain much reassurance from them and wish to see them maintained.¹
- 2.3. The reassurance that consumers get supports the regulatory objective to

promote competition. Previous research² revealed that consumers are more willing to take risks and shop around when they are confident there are regulatory protections in place and that the rules will be effectively enforced. A diverse range of providers is a precondition for consumers to exercise choice, but equally important is a strong consumer rights framework and redress mechanisms to turn to if these rights are breached.³

- 2.4. These benefits need to be set against the fact that the measures come at a considerable cost to the profession. For example, professional indemnity insurance is usually the third highest cost for solicitors after staff payments and office overheads⁴. Although premium levels fell overall in the 2012-13 insurance year the median premium was £5,743 for sole practitioners, £45,000 for 2-4 partners, £71,600 for 5-10 partners, and £132,424 for 11-25 partners.⁵ Bar Mutual, which is thought to be one of the more cost-effective

¹ Vanilla Research, *Risk and the role of regulation*, February 2013.

² See for example Legal Services Consumer Panel, *Choosing and Using Legal Services: Empowering consumers, possibilities and limitations*, January 2013 and Ed Mayo, *Confidence and Competitiveness: The new consumer policy agenda*, Labour's Policy Review, Labour Party, September 2012.

³ See Legal Services Consumer Panel, *Empowering Consumers, Phase One report*, March 2013, pp. 12-13.

⁴ See http://www.lawgazette.co.uk/files/PII_12.pdf, p. 15.

⁵ The Law Society, *2012-13 PII Survey*, April 2013.

schemes, costs on average £1000 per barrister for the primary layer cover.⁶

- 2.5. These costs may be passed on to consumers through higher prices (depending on the strength of competition in the market), so it is not in the consumer interest for protections to be disproportionate to the risks. Further, excessive measures may create barriers to entry that ultimately inhibit innovation and the development of responsive services which drive competition in the market.
- 2.6. Some aspects of financial protection arrangements have been reviewed in recent years.⁷ In addition, the Solicitors Regulation Authority (SRA) is currently undertaking a comprehensive review of its own arrangements, which is due to be published in autumn 2014. We are working closely with the SRA to ensure that our respective initiatives complement each other and do not duplicate effort.
- 2.7. However, financial protection arrangements have not been reviewed from a consumer interest perspective and this is where the Panel can add most value. Similarly, until now there has been no consumer research undertaken to establish views on the protections in place and whether these are considered adequate.

Information asymmetries

- 2.8. It is recognised that consumers of legal services generally lack the detailed knowledge needed to compare

services accurately and assess quality.⁸ Moreover, consumers of credence goods like legal services are often unable to judge the quality of advice even after it has been provided. Legal services tend to be purchased infrequently by individual consumers, which makes it difficult to compare advice against previous purchases. And when legal services are obtained it is usually in stressful situations such as moving house, family disputes or being involved in a court case.⁹ All these factors mean consumers are not easily able to tell high quality from low quality providers.

- 2.9. This market failure is addressed through regulatory intervention. Regulators authorise legal services providers to guarantee an acceptable level of quality on entry, and monitor the market on an ongoing basis. Their work can include, for example, setting requirements for continuing professional development or taking enforcement action against firms or individuals that breach the rules.
- 2.10. Financial protections are an important part of this. In some cases, such as residential conveyancing, consumers have no choice but to transfer large sums of money to their conveyancer in order to complete their house purchase. In other situations legal advisors may be in positions of trust, for example if they are an executor of a will. The amounts involved can be very large. Although data is fragmented due to different regulators collecting and

⁶ Information provided by Bar Mutual.

⁷ See for example Charles River Associates report for the Solicitors Regulation Authority, *Review of SRA client financial protection arrangements*, 2010, and Marsh, *Report to the CLC on professional indemnity and compensation fund arrangements* (summary), 2009.

⁸ For more in-depth analysis of information asymmetries in the legal services see Ministry of Justice, *Full Regulatory Impact Assessment, Legal Services Bill*, 2006 and Charles River Associates report for the Solicitors Regulation Authority, *Review of SRA client financial protection arrangements*, 2010.

⁹ Ministry of Justice, *Full Regulatory Impact Assessment, Legal Services Bill*, 2006, pp. 7-9.

holding it in various ways, the Panel has found:

- 1,321 claims were made on the SRA compensation fund, for a total of £31.6 million, and £18.5 million was actually paid out in 2012;¹⁰
- Bar Mutual made 32 payments over £50,000 between 2010 and 2012, and 7 of these payments were for amounts over £250,000;¹¹
- The average amount paid out by the CLC compensation fund is £30,000 to £40,000;¹²
- In the financial years 2011-2013 the Legal Ombudsman resolved around 110 cases with a financial remedy of over £10,000. There were 17 cases resulting in an award of over £20,000 in the last financial year.¹³

Regulatory regimes

2.11. The Legal Services Act 2007 requires Approved Regulators (and Licensing Authorities) to have appropriate insurance and compensation arrangements as part of their regulatory arrangements. These may include professional indemnity insurance, fidelity schemes and/or compensation funds. The arrangements also benefit the profession. They cover lawyers for civil liability claims. Moreover, the commitment to consumer protection such arrangements represent help to maintain public confidence in the integrity of the profession.

2.12. Other professional bodies also operate financial protection arrangements. The

Royal Institution of Chartered Surveyors (RICS) has a Clients' Money Protection Scheme, while the Institute of Chartered Accountants in England and Wales (ICAEW) requires all members who engage in public practice to have professional indemnity insurance. Some unregulated legal services providers, such as members of the Institute of Professional Willwriters, must also hold professional indemnity insurance.

2.13. Equally though, in other markets consumers may pay for goods or services before they are fully delivered and in some cases their payments are not protected: this could range from paying for building work (although there may be codes of conduct in place to reassure consumers), to buying expensive items of furniture. If the company becomes insolvent, the provider disappears with the money, or the work is not carried out to the standard the consumer expected, there may be limited options for redress.¹⁴

What the Panel was asked

2.14. The Legal Services Board (LSB) asked the Consumer Panel for advice on the regulators' financial protection arrangements in legal services. Their advice request consists of two overarching questions:

- The extent to which regulators' financial protection arrangements (including compensation) are adequate; and
- The appropriate level of risk consumers should be expected to bear.

¹⁰ Solicitors Regulation Authority, *Quarterly regulatory outcomes report*, December 2012.

¹¹ Information provided by Bar Mutual.

¹² Information provided by CLC.

¹³ This refers to the total remedy amount, which may include repayment of fees and other forms of resolution, and not just compensation payments.

¹⁴ Consumer Focus, *Pay Now, Pay Later*, 2009, p. 4.

2.15. Within these parameters the LSB asked the Panel to consider other, more detailed research questions:

- Whether consumers assume there are regulatory arrangements in place and that therefore there is no risk attached to choosing an advisor;
- The types of risks consumers face in this area;
- Evidence on how consumers assess and respond to risk, and their perception of regulatory protections within that; and
- The likelihood of consumers being either willing or able to insure themselves against some or all of the risks they face.

Scope

2.16. The advice request received from the LSB focuses on the arrangements of Approved Regulators and Licensing Authorities. As such unregulated legal advice is outside the scope of this study.

2.17. This research focuses on the financial risks most likely to be faced by individual consumers, small businesses, and charities – third parties such as banks or financial institutions have not been included within the scope of the research. Corporate buyers are recognised as being better able to assess risks and suffer less from the information asymmetries described above.

2.18. For the same reason the arrangements relating to costs lawyers, trade mark attorneys and patent attorneys are not dealt with in detail, as these groups of lawyers are more likely to deal with sophisticated and informed clients and

therefore the risk of financial detriment to individuals is smaller.

2.19. Fee levels (which may be challenged through the Legal Ombudsman) and awards from the Legal Ombudsman for poor service are also outside of scope. However, we have worked with the Legal Ombudsman Service to identify cases where it has liaised with professional indemnity insurers to ensure a complainant obtains redress, as well as where the Ombudsman has awarded financial compensation because poor service has led to an identifiable financial loss on the part of the consumer.

Methodology

2.20. In order to answer the research questions above, the Panel carried out a number of steps, including:

- A literature review to collect information on current regulatory arrangements and to research consumers' views on risk and the role of regulation in areas other than legal services, most notably food safety and financial services;
- 12 focus groups exploring consumer views on risk and the role of regulation – the independent report by Vanilla Research is available on our website;
- 11 interviews with expert stakeholders including approved regulators, professional indemnity insurers, representative bodies and the Legal Ombudsman; and
- A mapping exercise of existing arrangements to build up a picture of the existing financial protections for different regulated groups, and any gaps in these which could potentially pose a risk to consumers.

- 2.21. Those who provided us with data, including approved regulators, have had the opportunity to check the factual accuracy of this report.
- 2.22. In addition to this report, the Panel has published a separate paper exploring the wider issue of risk and responsibility, and the ways in which risk can be fairly shared between consumers and service providers.

Structure of the report

- 2.23. The report first addresses what success could look like from the consumer perspective, before mapping the current regulatory landscape and existing risks for consumers. We then assess the arrangements which are in place and give our views on their adequacy. The report ends with our conclusions and recommendations.

Thank you

- 2.24. The Consumer Panel is grateful to the individuals and organisations who contributed to the project, especially those stakeholders who provided data and gave their time to be interviewed as part of the project. We are also very grateful to the consumers who took part in our focus groups.

3 Risks to consumers

Key risks

3.1. The main financial risks to consumers can be grouped by theme:

- Theft of client money
- Failure to account for client money
- Other dishonesty
- Insolvency of provider
- Negligence
- Fraud (other than theft and dishonesty)

3.2. Stakeholder interviews revealed broad agreement that residential and commercial property conveyancing and wills, estate administration and probate are the highest risk areas of law. This is largely because the amounts of money involved here can be much higher than in other areas of law. At the Westminster Legal Policy Forum on the future of conveyancing and property transfer in December 2012, Richard Collins, SRA executive director of Policy, Standards, Strategy and Research, mentioned the strain conveyancing claims put on both professional indemnity insurers and the compensation fund. This included claims relating to conveyancing of £87 million on the compensation fund.

3.3. Other high risk areas are thought to include divorce (in cases where high assets are involved) and medical negligence. Thematically, client accounts are considered an area of significant risk by some stakeholders.

Where lawyers do not handle client money, risks (and consequently insurance premiums), are thought to be lower. For barristers, claims are made most frequently in the areas of chancery (contentious), personal injury and commercial. However, the highest amounts arise from the areas of personal injury and advice on tax mitigation or the viability of tax avoidance schemes.¹⁵

3.4. The available data appears to support these perceptions. In the sections below, we describe the risks and provide incidence data where available. It should be noted that data was in some cases quite difficult to find, and also because information has been gathered from various different places it is not always comparable. Overall, the lack of available data has made it challenging to assess the existing arrangements.

Theft of client money

3.5. Theft of client money and dishonesty more generally have been identified as one of the biggest risks to consumers in terms of financial protection. In practice the types of detriment caused to consumers by theft from client accounts could be, for example, a mortgage which is not paid off, a lost mortgage advance, or fees such as stamp duty, land tax or land registry fees, which are paid to the legal advisor

¹⁵ Information provided by Bar Mutual.

by the client but are then kept by the advisor rather than passed on to the relevant body. These risks can be extremely serious for consumers. Where a mortgage is not paid off, for example, the lender may repossess and sell the property. In some cases the problem may not be discovered by the consumer for some time (as the consumer assumes, for example, that the land registry fees have been paid and does not at first have any evidence to the contrary). This time delay can lead to further complications.

- 3.6. The SRA Forensic Investigations Unit carries out targeted investigations by visiting firms and adducing evidence in areas such as the misuse of client money, serious misconduct or malpractice, dishonesty, fraud and money laundering. 521 investigations were concluded in the 12 months to December 2012. As the results are not broken down by category it is not possible to say how many of the investigations related to misuse of client money specifically, but the SRA notes that accounts inspections make up the majority of visits.¹⁶
- 3.7. Additionally, in the 12 months to December 2012 the SRA effected 37 interventions. Of these 37 interventions, 26 were to protect the interests of clients/beneficiaries, 17 were due to breaches of the accounts rules, and 9 were due to suspected dishonesty (note that interventions may have multiple grounds).
- 3.8. The Solicitors Disciplinary Tribunal, which hears and determines applications in respect of solicitors concerning allegations of professional misconduct or breaches of the rules relating to professional

practice, reports that 5% of allegations made against solicitors in 2011-2012 related to client money (either improper utilisation or misappropriation). The Tribunal received 239 applications altogether over the period.¹⁷

- 3.9. The Council for Licensed Conveyancers paid out a total of £115,727 from the compensation fund in 2011 (the last year for which figures are available) for grants relating to dishonesty or fraud, although it is not possible to say what proportion of these grants related to misuse of client money specifically. Additionally, insurance premiums of £152,422 and legal and professional costs of £50,137 were paid out.¹⁸
- 3.10. In terms of holding client money only around 30 notaries currently carry out conveyancing and/or probate in their notarial capacity, and may therefore hold client money at some stage during these transactions.¹⁹ Because almost all notaries are sole practitioners (and it is not possible for an individual to insure themselves against their own dishonesty), notaries are required to have fidelity insurance. This is mainly provided through a scheme called Notaries Guarantee. The scheme has been in place for around 20 years and as of January 2013 there had been no claims made against it.²⁰

Failure to account for client money

- 3.11. Some stakeholders also identified failure to account for client money as a common risk. The Solicitors Disciplinary Tribunal Annual Report

¹⁶ Solicitors Regulation Authority, *Quarterly regulatory outcomes report*, December 2012.

¹⁷ Solicitors Disciplinary Tribunal Annual Report 2011-12.

¹⁸ See Council for Licensed Conveyancers Annual Report 2011, p. 13.

¹⁹ Figure provided by the Notaries Society and verified by the Faculty Office.

²⁰ Information provided by the Notaries Society.

2011-12, for example, reports that 33% of allegations against solicitors related to breaches of the Solicitors' Accounts Rules.

- 3.12. Any shortfall in a client account is called a deemed claim by insurers. These claims may be due to dishonesty, but may simply be down to bad bookkeeping. Professional indemnity insurers generally find out about such claims through an accountant after audit or because a partner at the firm finds out. However, as the money will usually be put back into the client account by the insurer, for practical purposes the consumer may never know that the money was missing for a period or even whose the money actually was (for example because the shortfall was in the main client account itself and not assigned to a particular individual consumer).
- 3.13. Another concern was that solicitors may give undertakings in a transaction such as conveyancing or in a settlement. This amounts to a legal contract with, for example, the lender in a conveyancing transaction. In some circumstances the law firm may make this contract before having received the money into their client account. Where this happens and the consumer does not then make the payment into the client account, the lawyer or law firm is still bound by the contract and has to pay out. This may then be covered by professional indemnity insurance. Although no direct consumer detriment is likely to be caused, it is a practice which may raise insurance premiums across the profession, which could then be passed on indirectly to consumers.
- 3.14. Failure to account was an issue for a number of the stakeholders we spoke to during this project, because, for example, it may indicate poor internal controls in firms. Although consumers

are not normally financially disadvantaged, insurers pointed out that poor internal controls may indicate other problems within a firm, and cautioned that insurers should not be used as regulators by proxy, discovering these problems and then trying to prune out the firms causing them through raising premiums.

Other dishonesty

- 3.15. Consumers may be financially disadvantaged in other ways than direct theft of money from client accounts. The Solicitors Disciplinary Tribunal Annual Report for 2011-2012 notes, for example, that across all the categories of allegations, specified dishonesty and/or a failure to exercise probity, integrity and trustworthiness was found in 20% of cases.
- 3.16. From the perspective of notaries, it is possible dishonest instruments could be drawn up (for example, in order to sell a property). This could benefit the notary or the client. The Notaries Guarantee fidelity scheme has so far had no claims made against it.
- 3.17. It has proved difficult to find specific data for other areas of law. Stakeholders considered wills, estate administration and probate to be a particularly high risk area where dishonesty can cause consumer detriment. For example, in cases where estate funds need to be collected and distributed there may be dishonest accounting, allowing money to be stolen. Dishonesty could also cover theft of property, such as taking a box of jewellery from a house when the lawyer is there to sort out the contents. This situation would be covered by solicitors' professional indemnity insurance, but of course the theft would have to be both discovered and proven

before the consumer could obtain redress.

- 3.18. Another example could be where a lawyer has a Power of Attorney and commits a large number of low value thefts over a long time (for example, cash is withdrawn each week for a client in a care home to use to pay for things like sweets, papers, and the hairdresser, but each week the lawyer withdraws money for him/her self at the same time). Or using a Power of Attorney the lawyer instead commits one high value theft and disappears with the money.

Insolvency of legal advisor

- 3.19. If a lawyer goes bankrupt there could be immediate consequences for the consumer such as not being able to get in touch with the solicitor or firm dealing with their case, not being able to access papers needed to progress their case, or money paid into the client account being frozen. In addition to this, where a consumer has paid for work to be done up-front that money may be lost.
- 3.20. Interventions mean that the firm in question is closed with immediate effect, the bank accounts are frozen and papers are seized. Although intervention agents attempt to identify and contact clients with urgent cases immediately, the client will then have to find another advisor to complete the work. In addition to this, if the firm has been closed because of breaches of the accounts rules, or dishonesty, the client may find that money belonging to them has disappeared. Although the financial protection arrangements will protect the client, claims may take time to process, and cause a great deal of stress to the consumer.

- 3.21. In the 12 months to December 2012, 37 SRA interventions took place, 8 of which were due to bankruptcy or insolvency of the firm.²¹ There are reports that the number and cost of interventions is increasing in 2013.

- 3.22. It became clear during our focus groups that consumers did not tend to consider that their legal advisor could become insolvent and cause risk to them – in reality consumers did not think about the issue.

Negligence

- 3.23. Professionals who give inadequate advice or take actions which result in financial loss may be said to have been professionally negligent.
- 3.24. In terms of financial risk to consumers, professional negligence can cover a wide variety of scenarios:
- In conveyancing, negligence could mean a property is not registered correctly in the buyer's name, fees and taxes such as stamp duty are not paid, or mortgage payments to lenders may not be properly made, leaving the consumer open to huge losses.
 - In the area of will-writing, previous research by the Consumer Panel uncovered technical problems with wills which meant assets could go to unintended people, or result in higher tax bills or sale of the family home.²²
 - In cases where financial assets are at stake, such as in a divorce, negligence by a barrister or solicitor could mean that one partner does

²¹ Solicitors Regulation Authority, *Quarterly regulatory outcomes report*, December 2012.

²² Legal Services Consumer Panel, *Regulating will-writing*, July 2011.

not receive the full amount they are entitled to.²³

- Negligence in personal injury cases could mean a consumer does not receive the full settlement they should have.

3.25. Stakeholders have told us that negligence leading to financial loss is a problem. Most claims to solicitors' indemnity insurers, for example, were considered to result from negligence rather than dishonesty. Negligence can arise for different reasons, for example, because paralegals are carrying out work which is insufficiently vetted, due to pressures on fee earners to complete large volumes of work quickly, or because a firm does not have sufficient supervisory and risk controls in place.

3.26. It is difficult to find good data relating to professional negligence. Ministry of Justice Judicial and Court Statistics (Chancery Division) show 125 professional negligence claims against solicitors in 2011. In contrast to this there were no claims against accountants, surveyors or estate agents, and 59 claims against members of 'other professions'.

3.27. The same report shows 227 'other' negligence claims were started in 2011 in the Queen's Bench Division. Unlike for the Chancery Division, this figure is not sub-divided by profession, so the proportion of claims relating to solicitors (if any) cannot be derived. Moreover, these statistics show only those cases which reached the High Court, and also of course, only those cases where a consumer was able to instruct another solicitor and pursue a negligence claim.

3.28. However, evidence from our focus groups shows that the expense, aggravation and uncertainty of outcome means in practice consumers are reluctant to do this. Additionally, claims which are settled between consumers and professional indemnity insurers before reaching court will not be reflected here, nor will cases where some form of alternative dispute resolution such as mediation has been used to settle a claim. The pre-action protocol, which must be followed for professional negligence claims, encourages early settlement of a dispute where possible.

3.29. Indemnity insurance claims data is commercially sensitive and so largely not in the public domain. Solicitors' indemnity insurers underwrote £239 million for the compulsory layer of SRA insurance in 2012²⁴ – however, this figure simply denotes all mandatory cover purchased by SRA regulated law firms and does not divide the cover purchased into risk areas, so it is not possible to see how much risk comes from negligence as opposed to other risks, such as theft from client accounts. Although such data is not in the public domain it would be useful if the regulators were able to access it.

3.30. The most recent data available from the CLC is from 2011. The 2011 Annual Report shows claims paid from the compensation fund for negligence which were not covered by the CLC Master Policy. These show £114,600 paid out in claims, with insurance premiums of £120,677 and professional fees of £58,803.

3.31. The Legal Ombudsman Scheme Rules allow the Ombudsman to refer certain

²³ Legal Ombudsman, *The price of separation, divorce related legal complaints and their causes*. See the cases studies in this report, in particular 'Ms E' and 'Ms F'.

²⁴ <http://www.legalfutures.co.uk/latest-news/new-indemnity-insurers-capture-market-share-solicitors-pay-less-cover-year>.

cases to professional indemnity insurers or the relevant Approved Regulator. Memoranda of Understanding also operate between the Ombudsman and the Approved Regulators. These documents set out how the bodies will work together and require the Ombudsman to inform regulators when misconduct has taken place so that the regulators may take disciplinary or other action. Between May 2012 and January 2013 around 120 cases were referred to indemnity insurers or regulators' compensation funds by the Legal Ombudsman.

Fraud (other than theft and dishonesty)

- 3.32. We have distinguished fraud from theft of client money and other dishonesty. Common examples of fraud could be mortgage fraud, where a mortgage is arranged by deliberately giving the lender inaccurate information, perhaps by not disclosing the true purchase price or the borrower's true financial position to the lender. A recent survey by the SRA found that a quarter of conveyancing firms they spoke to had experienced a client attempting to commit property-related fraud or money laundering.²⁵ Fraud may also involve money laundering by passing money through a solicitor's bank account. In some cases firms may not be aware they have been targeted.
- 3.33. There are strict rules surrounding fraud and money laundering. In some cases, fraudulent activities by solicitors will not cause financial detriment to individual consumers. This is because such activities may be carried out with the participation of the consumer, for example if they wish to take out a mortgage they otherwise could not

have. However, there is no doubt that such activities are not in the public interest and may also have an effect on the way lawyers are perceived by the general public.

- 3.34. There is evidence that fraudulent activity, particularly in the conveyancing area, could be putting consumers at risk. A recent BBC Radio 4 Moneybox²⁶ programme found that money for house purchases had been paid by legitimate firms of solicitors acting for buyers to what later turned out to be criminals posing as legitimate solicitors. The judgment in *Davisons Solicitors and Nationwide Building Society*²⁷ found that Davisons (a legitimate solicitor who paid £185,000 to what turned out to be a fraudulent office of an existing solicitor) were not liable for the money they had paid to the fraudulent branch. This raises the possibility of a situation where a consumer has transferred money to a solicitor in good faith and that solicitor has paid it on, also acting in good faith. However, where the recipient turns out to be fraudulent it is unclear how the consumer will be reimbursed (if at all).
- 3.35. The *Davisons* judgment also found that the Law Society and SRA websites showed inaccurate information, and continued to list a fake branch of a legitimate solicitor after they had been informed of the inaccuracy. The Moneybox programme highlighted 9 similar cases where sophisticated criminals had tried to perpetrate fraud between July 2012 and April 2013. However, a representative from the SRA was unable to say definitively on the programme that the published list of solicitors could be relied upon to

²⁵ See <http://www.legalfutures.co.uk/latest-news/quarter-conveyancers-experienced-attempted-fraud-third-pay-referral-fees>.

²⁶ BBC Radio 4 Moneybox, Sunday 21 April 2013.

²⁷ See <http://www.bailii.org/ew/cases/EWCA/Civ/2012/1626.html>.

identify only legitimate solicitors. The SRA also currently refuse to take responsibility where a solicitor has relied on their list and transferred money to what turns out to be a fraudulent person posing as a genuine solicitor. This leaves the consumer in a situation where they may be unable to get redress for potentially very large amounts of money. The SRA compensation arrangements are currently under review and this is something which should be addressed during that review.

4 Mapping the current landscape

Overview of current financial protections

- 4.1. Before we can make an assessment of the adequacy of current arrangements, we need to understand what is actually in place. What emerges is a diverse range of protection regimes, specific to each of the professions. The question is then whether these regimes adequately address the main financial risks facing consumers. The main financial protections are briefly described below (more detailed information can be found in annex 2).
- 4.2. Under the Legal Services Act 2007 approved regulators have made provision for indemnification and compensation arrangements as part of their regulatory arrangements. Section 21 of the Act sets out what references to regulatory arrangements are and includes indemnification arrangements and compensation arrangements.
 - Indemnification arrangements are defined as arrangements for ensuring the indemnification of those who are or were regulated persons against losses arising from claims in relation to any description of civil liability incurred by them (or by employees or former employees), in connection with their activities as such regulated persons.
 - Compensation arrangements are fairly broadly defined and mean arrangements to provide for grants or payments to relieve or mitigate losses or hardship suffered due to negligence, fraud or other dishonesty, or failure to account for money received in connection with their activities as such regulated persons.
- 4.3. In addition to this, the Solicitors Act 1974 (amended by Schedule 16 of the LSA 2007) allows the Law Society to make rules concerning grants of compensation, establishing or maintaining compensation funds, providing indemnity, and providing redress for inadequate professional services. Finally, the Administration of Justice Act 1985 applies to the Council for Licensed Conveyancers in addition to the Legal Services Act 2007. This lays down certain requirements, including those relating to professional indemnity, compensation and insurance.

Solicitors

- 4.4. The SRA is the largest regulator in the legal services sector: their regulated population comprises 128,169 practising solicitors and 10,827 solicitor firms.²⁸

²⁸ SRA key statistics. Figures correct March 2013.

- 4.5. All firms carrying on a practice have to take out and maintain insurance. This insurance must be provided by SRA 'Qualifying Insurers', who agree to provide minimum terms and conditions which are set by the SRA. The minimum terms and conditions cover all civil liability arising from private legal practice in England and Wales, and there are very few exclusions. The sum insured for any one claim (exclusive of defence costs) must be, where the insured firm is a recognised body or a licensed body (in respect of its regulated activities), at least £3 million, and in all other cases, at least £2 million, on a per claim basis. The insurance must also provide run-off cover for an additional six years.
- 4.6. There are currently 26 qualifying insurers. Those with the largest market share for the 2012-13 indemnity year were XL Insurance, Travelers Insurance, QBE International Insurance and Zurich.²⁹
- 4.7. The SRA also administers a compensation fund which provides grants to consumers who have suffered loss due to dishonesty or failure to account. The compensation fund is funded by a levy on the profession. The compensation fund contribution for the practising year 2012-13 was £92 for an individual commencing practice on or after 1 November 2012, and £1,340 for recognised sole practitioners and recognised and licensed bodies holding client money.³⁰

²⁹ See <http://www.sra.org.uk/solicitors/code-of-conduct/professional-indemnity/income/estimated.page>

³⁰ See <http://www.sra.org.uk/mysra/fees/fee-policy-2012-2013.page>.

SRA reviews

- 4.8. The SRA has made major changes to the way client protection works in recent years, including changes to the Compensation Fund, as well as the Assigned Risks Pool (a 'safety net' for firms that cannot get cover from qualifying insurers in the open market), which will be abolished entirely from October 2013. The SRA is also currently undertaking a comprehensive review of financial protection arrangements, the results of which are due to be published in 2014.

Barristers

- 4.9. The Code of Conduct of the Bar of England and Wales states that every self-employed barrister must be covered by insurance against professional negligence and be entered as a member with the Bar Mutual Indemnity Fund. All self-employed barristers renew their cover on 1 April. Chambers receive a list of those barristers who have not completed their renewal or paid their premium, and they may be reported to their Head of Chambers and to the Bar Standards Board (BSB).
- 4.10. Bar Mutual premiums are calculated by reference to fee income and to the areas of practice in which members work. The minimum level of cover is £500,000 and the maximum is £2,500,000. However, members can also buy higher limits of cover through Bar Mutual or in the open market.
- 4.11. In the year to March 2012 Bar Mutual wrote £15 million in premiums and incurred £11 million in net claims.³¹
- 4.12. Barristers are not allowed to receive or handle client money or other assets,

³¹ BMIF Directors Report and Financial Statements for the year ended March 2012.

and so risks to consumers tend to be low in this area. However, in some cases it would be useful if barristers could handle client money, for example:

- To pay court fees;
- To make arbitration payments;
- With regard to settlement monies;
- Retainers;
- Contingent fee arrangements.

4.13. In order to allow barristers to carry out these functions a new escrow service, BARCO, which is a third party company, owned and operated by the Bar Council, is currently being rolled out. The service is independent and is regulated by the Financial Conduct Authority. The prohibition on handling client money will, however, remain in place.

4.14. The BSB has submitted an application to the LSB for approval of the new BSB Handbook, which includes some changes to the client money area. The application is currently under consideration.

Licensed Conveyancers

4.15. The Council for Licensed Conveyancers (CLC) regulates around 1,100 individuals and approximately 200 firms.³² Services should only be provided by individuals or bodies who have CLC-approved professional indemnity insurance in place. This can either be provided through the CLC Master Policy (currently there are two insurers under the Master Policy), or through another insurer, where the CLC is satisfied that the cover provided is at least equivalent to that provided

under the Master Policy. In practice only a few firms have opted out of the Master Policy. The Master Policy has a limit of £2 million for one claim, plus costs and expenses.³³ CLC regulated firms are required to purchase 6 years run-off cover when they stop practising.

4.16. The CLC also operates a compensation fund which covers fraud, dishonesty and failure to account, as well as negligence. It is funded by a yearly levy on licensed conveyancers. In 2012 the minimum fee was £500 for firms with a turnover of £100,000 or less, rising to £9,600 plus a proportion of turnover for those firms whose turnover exceeds £3 million.³⁴

Chartered legal executives

4.17. ILEX Professional Standards (IPS) have submitted an application to the LSB to become an Approved Regulator for awarding probate practice and reserved instrument rights, as well as rule change applications for litigation and immigration. If the application is successful, IPS will become a regulator of entities for the first time. As part of their application IPS have therefore set out the financial protection arrangements they intend to put in place if the application is approved.

4.18. The protections will include professional indemnity insurance provided by open market insurers who sign up to minimum terms and conditions. A Qualifying Insurers Agreement is currently being drafted. There will be a maximum limit of £2 million per claim and practitioners will

³² Council for Licensed Conveyancers Annual Report 2011, p. 25.

³³ Marsh, *Report to the CLC on professional indemnity and compensation fund arrangements* (summary), 2009, p. 15, Appendix B.

³⁴ See Council for Licensed Conveyancers Fees Framework 2012 (http://www.clc-uk.org/pdf_files/regulatory_arrangements/other/CLC_Fees_Framework_2012.pdf).

have to buy six years' worth of run-off cover.

- 4.19. IPS also intend to set up a compensation fund, similar to those currently run by the SRA and the CLC. Applicants to the fund will have to prove hardship before a claim is paid out.
- 4.20. At the same time the possibility of setting up an escrow account for use by IPS regulated entities is being investigated. This could have a number of advantages, including the fact that all annual auditing would be outsourced to the escrow company, a benefit for sole practitioners.
- 4.21. Currently almost all chartered legal executives are employed in solicitors' firms, and as such are covered by the SRA's rules. In addition to this we are aware that some chartered legal executives that carry out immigration work have obtained their own professional indemnity insurance on the open market.

Notaries

- 4.22. Notaries are qualified lawyers, regulated by the Court of Faculties. Within England and Wales a notary is authorised to carry out reserved legal activities as defined in the Legal Services Act 2007: namely, notarial activities, reserved instrument activities, probate activities and the administration of oaths, subject to the Notarial Rules governing the profession. However, notaries primarily deal with authentication and certification of signatures and documents for use abroad and general legal practice. Notaries who are also solicitors carry out most of their domestic work (including litigation) in their capacity as solicitors and are subject to regulation by the SRA.

4.23. Notaries must be fully insured and maintain fidelity cover for the protection of their clients and the public. They must keep client money separately from their own and comply with the Notaries Practising Certificates Rules, the Notaries Accounts Rules 1989 (as amended), and the Notaries Practice Rules 2009 (as amended).

- 4.24. The current minimum limit for professional indemnity insurance is £1 million. At the moment there is no prescribed figure for fidelity insurance cover. However, there are new Notaries Practising Certificate Rules which are due to come into effect in October 2013. These will introduce a minimum limit which will be fixed from time to time by Order of the Master of the Faculties. When first introduced, the minimum limit of fidelity insurance is likely to be not less than £1 million.
- 4.25. Because all notaries have to hold both professional indemnity insurance and fidelity insurance, notaries are not required to have a compensation fund. Notaries may practice in conjunction with their solicitor's practice but must maintain a degree of professional independence. However, it is possible that notarial practice by a solicitor in conjunction with their solicitor's practice may be covered by the SRA compensation fund should a claim arise.

Accountants

- 4.26. The Institute of Chartered Accountants in England and Wales (ICAEW) has applied to the LSB to become an approved regulator and licensing authority for probate activities. As part of their application ICAEW set out the financial protection arrangements they would put in place for those in their regulated community conducting

probate activities, if the application were to be approved.

4.27. These arrangements would include rules on holding client money and a requirement to hold professional indemnity insurance. Insurance is provided by 'participating insurers' who agree to provide terms which meet ICAEW's approved minimum wording. For probate practitioners there is a minimum limit of £500,000 per claim. Run-off cover should be maintained for at least two years.

4.28. There is also a probate compensation scheme which is funded by a levy on firms. The scheme may make grants on a discretionary basis. Only bodies corporate or registered charities with an annual turnover of less than £1 million in the previous accounting year are eligible to apply for a grant. An applicant would have to show that they had suffered loss due to fraud or dishonesty, or failure to account for money. Applications should be made within 12 months of the time when the loss came (or should reasonably have come) to the knowledge of the applicant.³⁵

Legal Ombudsman

4.29. The Legal Ombudsman can award compensation to consumers up to a maximum of £50,000, although this level of compensation is only likely to be awarded where a consumer is able to show a direct financial loss due to the lawyer's actions.³⁶ The Legal Ombudsman can refer cases to professional indemnity insurers where they feel this would be appropriate.

4.30. The Legal Ombudsman has told us that cases are typically referred to indemnity insurers where the firm is unable to meet the payment (for example because they have closed down or gone into administration). It is also possible that where the Legal Ombudsman makes an award and this is not met either by the firm or by professional indemnity insurance, the award could then fall on a regulators' compensation fund. Between May 2012 and January 2013 approximately 120 cases were referred to indemnity insurers or regulators' compensation funds by the Legal Ombudsman.

4.31. An overview table highlighting the main points of each regulator's financial protection arrangements follows.

³⁵ http://www.legalservicesboard.org.uk/Projects/pdf/20121214_icaew's_probate_application_anx_9-23.pdf, annex 18.

³⁶ Legal Ombudsman, *A Guide to our Revised Scheme Rules*, p. 3.

Table 2: Overview of arrangements

	Professional indemnity insurance	Minimums and maximums	Run-off cover	Compensation fund	Hold client money	Use of escrow
SRA	Qualifying insurers, open market, minimum terms and conditions. Cover cannot be excluded because premiums have not been paid.	Where the insured firm is a recognised body or a licensed body (in respect of its regulated activities), at least £3 million, and in all other cases, at least £2 million, on a per claim basis.	6 years – if run-off premiums are not paid the last firm to provide insurance remains on risk for run-off cover.	Discretionary, provides help where a consumer has suffered loss because of dishonesty or failure to account for client money.	Yes	Currently investigating
BSB	All compulsory insurance provided by Bar Mutual Indemnity Fund (BMIF). Higher limits of cover available through BMIF or the open market.	Minimum compulsory level of cover is £500,000 and maximum is £2.5 million.	Cover continues while Bar Mutual continues to provide insurance to the self-employed Bar as a whole.	No	No	Escrow (BARCO) has received FCA authorisation and is being rolled out.
CLC	Master Policy or through an open market insurer where the CLC is satisfied the cover is at least equivalent.	£2 million per one claim plus costs and expenses	6 years. Run-off cover is only provided if premiums paid – otherwise claims fall on the compensation fund.	Discretionary, covers fraud, dishonesty, negligence and failure to account.	Yes	No
Notaries	Open market insurance	£1 million	Run-off cover is not required. Some notaries	No compensation fund – hold fidelity insurance.	Yes – but limited numbers of notaries hold	No

			continue their insurance policy after they have ceased to practice in order to provide run-off cover.	This provides £1m of cover (across the whole scheme not per notary/claim).	client money	
IPS (proposed scheme)	Open market using qualifying insurers and minimum terms and conditions.	£2 million per claim. Currently chartered legal executives that work in solicitors firms are covered by the SRA rules.	6 years	Yes, discretionary, will cover sole practitioners and dishonesty. The fund will also be insured.	Yes	Currently being investigated
ICAEW (proposed scheme for probate and estate administration)	Participating insurers who agreed to meet an approved minimum wording.	For probate practitioners there is a minimum limit of £500,000 per claim.	2 years	Yes, discretionary. Includes bodies corporate or registered charities with an annual turnover of less than £1 million.	Yes	No

Treatment of small businesses and charities

- 4.32. Throughout this paper we have referred to individual consumers. However, we have also included the treatment of small businesses and charities within the scope of our review. Overall these bodies are treated in a similar way to individuals, with some differences, which are set out below.
- 4.33. In general, all individuals and entities making a claim against professional indemnity insurers are treated in the same way – the claim will either be settled if it has merit or fought if it does not. However, it is possible that the claimant's degree of knowledge and power might be relevant, for example a claim by an individual might be treated differently to one made by an experienced property developer, if (for example) the allegation concerned failure to advise on business matters.
- 4.34. Bar Mutual raised the point that although all claims are dealt with in the same manner, it is possible for a defendant to demand security for costs from a company claimant. For example, if there were concerns about the ability of an incorporated small business bringing a claim against a barrister to pay the barrister's costs (in the event the claimant lost), an order for security for costs could be made. If such an order were to be made and the sum ordered to be paid into court were not paid, the proceedings would likely be stayed. This could make small businesses less likely (or less able) to bring a claim against a barrister.
- 4.35. In terms of compensation funds, the SRA does not place restrictions on who can make a claim. However, if the

claim relates to a failure to account, the SRA must also consider whether the applicant has suffered hardship. An award can only be made if hardship is shown. An individual is deemed to have suffered hardship and does not need to provide evidence of this, irrespective of their personal wealth. However, a corporate body or an individual whose dealings with the regulated person or firm were in a business capacity must provide evidence to satisfy the SRA that hardship has been or is likely to be suffered.

- 4.36. Finally, ICAEW exclude organisations or registered charities with an annual turnover of £ 1 million or more from their compensation fund. IPS, on the other hand, have stated in their application that any 'person' may make a claim. Person would be interpreted in accordance with the Interpretation Act, which means small businesses and charities that are able to demonstrate a loss would be able to make a claim.

5 Adequacy of arrangements

What would success look like?

- 5.1. Before assessing the adequacy of the current arrangements, the Panel first set out to define what success would look like in a legal services context. In doing this we have drawn on learning from the financial services sector, where there is a single scheme. In terms of information asymmetries, the financial services market is similar to the legal services market. We have also drawn more widely on the established principles of consumer protection. These include elements like accessibility, transparency and fairness.
- 5.2. The best outcome is that consumers should be covered in cases of financial loss caused by insolvency, negligence, fraud, dishonesty or failure to account, through a mandatory scheme. We then considered how best to achieve this goal from the consumer perspective. Our analysis suggests the following indicators would signify good practice:
- There should be comprehensive coverage of risks, which is appropriate to the level of risks consumers face, and the elements should work well together with no gaps. Gaps in the arrangements mean that consumers could ‘fall between’ protections, and end up with none at all.
 - Financial protections should be accessible to users who need them, and it should be clear how to use them.
 - The arrangements should work efficiently. For example, consumers should not have to wait lengthy periods to obtain redress, particularly where large sums of money are involved or where a consumer needs to access funds quickly, such as to ensure a house purchase can be completed. Where the financial protection arrangements are engaged, disruption to the consumer should be minimised.
 - There should be transparency over the decision-making process – this is key to ensure that all claimants are treated fairly, as well as to make sure the arrangements are open to scrutiny from all stakeholders. This should include accountability criteria which arrangements can be assessed against.
 - Schemes should be operated independently of the profession. As a regulatory arrangement, financial protection regimes should be administered in a way consistent with the LSB’s Internal Governance Rules framework. Underpinning this is the principle that structures or persons with representative

functions must not exert, or be permitted to exert, undue influence or control over the performance of regulatory functions. This is important given, for example, decisions over the size of the levy which funds the schemes as well as exercise of discretion on individual claims to compensation funds. (This aspect has not been reviewed since compliance is assessed by the LSB in its IGRs audit process.)

- There should be ways for the different organisations involved in the market to share information. This could help detection of issues before they become a problem, or enable effective action when a problem is discovered.
- Arrangements should be risk based. This means that providers who are considered to pose a higher risk should contribute more to protection arrangements than those who pose a lower risk. In practice this means the incentives of legal services providers will be aligned with those of consumers, since those providers who have the best systems and controls in place, or those who do not carry out high risk activities, will pay lower premiums towards protection measures like professional indemnity insurance and compensation schemes.
- Finally, the arrangements should be cost-effective.

Assessing the current arrangements

- 5.3. The previous sections set out the regulatory arrangements which are currently in place, as well as the risks consumers may face. Many of the arrangements are similar, but with some key differences depending on

each regulator and the particular type of lawyer and work they regulate. These arrangements need to be assessed in turn against the success indicators. We have chosen to focus thematically rather than taking each regulator's arrangements in turn as our aim was to underline shared features between schemes and to highlight strengths and weaknesses across the financial protection regimes as a whole.

Comprehensive coverage of risks

- 5.4. As it is difficult for consumers to assess the quality of legal services providers and to make informed choices, and they are also not able to assess or manage the risks involved, comprehensive financial protection arrangements are important. Overall, we consider the arrangements in place do cover the main risks. However, we have identified a number of limitations, which are listed below.

Value of assets exceed value of insurance

- 5.5. All the regulatory arrangements described above set a cap on claims: these are detailed in Table 2. For practical purposes it is desirable that caps are in place – insurers would be very unlikely to underwrite open ended liabilities! This is one of the reasons why regulators have to make judgements about risk, and there is a division of risk between consumer and provider.³⁷ In most cases (depending on the regulator and the type of work being carried out) consumers are covered for losses somewhere between £500,000 and £2 million.

³⁷ For more info see Legal Services Consumer Panel, *Risk and responsibility, implications for regulating legal services*, May 2013.

- 5.6. Although broadly similar, the caps differ between different regulators. Note that it is possible for firms to buy top-up insurance to provide a higher level of cover if they wish to do so. Different caps are an example of differing levels of cover for consumers, who may in some cases have had the same work carried out by different types of lawyer. Although it is likely that caps developed organically, it is now more difficult to justify such differences, especially given that in many cases similar or the same work may have been done.
- 5.7. In most cases the Panel did not find evidence of disclosure duties, where the provider has to point out to the client if they are at risk of exceeding the cap. ICAEW's application, however, does include a provision that firms must inform clients where the value of an estate is likely to exceed the level of PII cover.
- 5.8. The ongoing case of *Godiva Mortgage Ltd v Travelers Insurance Company*³⁸ illustrates the possible risk that consumers could be left out of pocket due to the use of caps. The case concerns a partner at a law firm who was involved in a number of allegedly fraudulent property transactions. When the losses came to light numerous claims were brought against the firm, including by the claimant, Godiva, a lender. The law firm has gone into liquidation and cannot meet the claims. The insurer asserts that all the activities from the partner's involvement in alleged fraudulent activity can be aggregated as one claim and therefore

capped at £2 million. However, the total losses in the case could exceed £50 million in reality.

- 5.9. The Law Society and the SRA have both been given permission to intervene in the case by the High Court. The SRA in particular is concerned that the case could impact on the compensation fund if the insurer is able to aggregate the claims. This would mean the fund would be liable for all claims beyond the £2 million mark. The risk to consumers is that where very large losses such as this arise there is a possibility that claims may not be met. Furthermore, should the compensation fund become liable for such a high number of claims, it is likely the SRA would have to levy law firms and this would ultimately be passed on to consumers in the form of higher charges. The case is currently due to be heard in the first half of 2014.

Insolvency of insurance firms

- 5.10. A high risk, in the view of those interviewed as part of the study, are poorly rated or unrated, insurers in the market.³⁹ Research found that in the 2012-13 insurance year 16% of firms used unrated insurers, an increase on the previous year, and small firms were more likely to use unrated insurers.⁴⁰
- 5.11. There is concern that these insurers 'underprice' their premiums, which is unsustainable over the longer term. If an insurer ceases trading during the indemnity year, solicitors would then have to buy another policy mid-year, without being able to recoup the fees already paid for the first policy. The

³⁸ See for example

<http://www.postonline.co.uk/post/news/2139244/law-fight-travelers-pi-refusal>, <http://www.russell-cooke.co.uk/about-news-story.cfm?id=122&all=1> and <http://www.legalfutures.co.uk/latest-news/law-society-and-sra-join-forces-to-fight-50m-indemnity-insurance-case>.

³⁹ See for example

<http://www.travelers.co.uk/onrisk/article1.html> and The Law Society, *The importance of insurer solvency*, January 2013.

⁴⁰ The Law Society, *2012-13 PII Survey*, April 2013.

SRA does not approve or rate insurers who sign up to the Qualifying Insurers Agreement (insurers are authorised and regulated by the Financial Conduct Authority), although there is a transparency provision which makes it mandatory for insurers to disclose credit and financial strength ratings. Insurers also have to state if they are unrated. This information can be taken into account by law firms when renewing their policies – something the Law Society encourages firms to do. In addition, these concerns may be partly addressed by the forthcoming Solvency II legislation, which will increase the capitalisation of insurers.

- 5.12. An insurer which has ceased trading might not be able to meet claims. In the event of this happening it is possible the law firm would be covered by the Financial Services Compensation Scheme (FSCS). However, there are limits on this, for example, firms whose turnover exceeds £1 million may be excluded, and compensation is limited to 90% of the total claimed.
- 5.13. Insolvency of insurance firms has already caused problems in the market in the past. The high profile failures of insurers Quinn in 2010 and Lemma in 2012, for example, caused concern amongst solicitors that there could be an inability to settle claims which had not been finalised at the time the insurer went into administration, or claims against law firms which had gone into run-off.

Discretionary nature of compensation funds

- 5.14. Compensation funds are discretionary and in some cases there are tests to be met before a grant can be paid. For the SRA scheme, as well as that proposed by IPS, consumers must meet a hardship test. It is difficult to find

information on how tests like this are assessed, although the SRA state that individual consumers will meet the test automatically and it is corporate bodies or individuals whose dealings were in a business capacity that must provide evidence to show that hardship has been or is likely to be suffered. It may be that in practice the hardship criteria is there to stop corporate claims, such as those made by lenders, who are arguably more informed than individual clients,⁴¹ from draining the funds.

- 5.15. Other evidence suggests that claims on compensation funds can be rejected. 1,321 claims were made on the SRA compensation fund, for a total of £31.6 million, but of this only £18.5 million was actually paid out in 2012. The SRA told us that the difference between the value of claims made and the actual amount paid out is partly due to claims being received which are outside the scope of the fund. For example:
- Some people claim prematurely: where there is the possibility to seek redress by another means, and in circumstances where the SRA considers it would be appropriate for them to pursue those avenues first;
 - Certain losses will not be considered as part of an award: for example claimants may include consequential losses in their application, but these are not covered by the fund.
- 5.16. Depending on the circumstances, asking consumers to exhaust other avenues of redress first can cause detriment. In an Australian case, for example, where over AUS \$2 million was stolen from client accounts, consumers were not allowed to access

⁴¹ Charles River Associates report for the Solicitors Regulation Authority, *Review of SRA client financial protection arrangements*, 2010, p. 43.

the compensation fund until they had exhausted other avenues of redress. This meant the claimants had to go to court, and faced huge costs for doing so. One couple told of how they lost AUS \$500,000 and had costs of around AUS \$150,000 for legal fees, while another couple had to sell their family farm to pay for their costs.⁴² A draft bill has now been tabled which seeks to resolve the question of when access to the fund is justified. This proposes that a claimant need not pursue other recourse where a reasonably prudent self-funding litigant would not do so, and is based on the merits test for the allocation of legal aid in Australia.⁴³

- 5.17. The CLC responded to an LSB request for information as part of the LSB's Conveyancing Review. The response provides the information that over 50% of claims to the compensation fund were rejected, but no explanation was given as to why this is.⁴⁴ Additionally, the CLC Annual Report 2011 states that three cases previously determined by the CLC were subject to a Judicial Review in 2012, the outcome of which was that the CLC will reconsider the applications in order to determine if any payment should be made from the compensation fund.

⁴² See

<http://www.theaustralian.com.au/business/legal-affairs/the-moment-of-truth-is-near-for-the-man-who-killed-magarey-farlam/story-e6frg97x-1225968493593> and <http://news.smh.com.au/breaking-news-national/former-law-clerk-guilty-over-theft-20101014-16l1b.html>.

⁴³ Legal Practitioners (miscellaneous) Amendment Bill 2012 (Australia), see Ministerial Statement, 13 March 2012.

⁴⁴ Legal Services Board, *Conveyancing Review*, December 2012, p. 13.

- 5.18. A case study on the Legal Ombudsman website,⁴⁵ deals with a case where the solicitor did not register the claimants with the Land Registry, leaving them with a bill for unpaid stamp duty. The SRA then intervened in the firm. The claimants asked for help from the compensation fund but were told the stamp duty fee was not covered. They therefore went to the Ombudsman, who found the appropriate remedy would be for the remaining partner in the firm to cover the stamp duty fee. However, because the firm had been intervened in the couple had to accept that in practice it might be difficult to enforce the decision. The case study concludes that the Ombudsman is working with the SRA to establish what can be done to help people in this position.

- 5.19. These examples show that sometimes people are left out of pocket and are not able to get their money back. Where payments such as stamp duty are involved, the financial stakes involved can be high.

- 5.20. Some regulators have explicit maximums on grants which can be made. The SRA maximum, for example, is £2 million, although this rule can be waived. IPS, on the other hand, has a cap of £500,000 which is the maximum grant which can be made. The assets in a discretionary compensation fund may also be taken into account when deciding on grants. The CLC lists various criteria which it may take into account (without limiting its absolute discretion) when deciding whether a claim should be paid, reduced or rejected. One of the criteria is the assets available to the fund.

- 5.21. ICAEW, (currently applying to the LSB to become an approved regulator and

⁴⁵ http://www.legalombudsman.org.uk/decisions/decisions_property.html, the case of 'Mr and Mrs F'.

licensing authority for probate activities) has an explicit cap of £5 million in total in grants which can be paid out in a given year. If claims in excess of this are received then all remaining grants for the year will be reduced. These reductions may be made good in the next financial year but this is at the discretion of ICAEW's Probate Committee. These provisions mean there is the possibility that should a systemic issue arise which stresses the funds, those consumers who claim 'last in the queue' could be disadvantaged and may not have their claims met. Given the level of claims in the *Godiva* case mentioned above, there is scope for considerable consumer detriment.

- 5.22. Currently, stakeholders have mentioned the scenario of large numbers of claims arising from stamp duty land tax schemes and 'right to buy' negligence litigation. These, or similar wide reaching issues, have the potential to stretch the discretionary nature of funds.

Limits to run-off cover

- 5.23. Some gaps have been identified in relation to run-off cover. The SRA rules oblige insurers to cover run-off for six years, even if run-off premiums have not been paid. This is in-line with the statute of limitations. The Law Society also provides some supplementary run-off cover.
- 5.24. However, gaps in other regulators' arrangements exist. For example consumers using ICAEW regulated firms for probate activities would not be covered in cases of negligence where indemnity insurance or run-off cover has not been maintained. ICAEW's compensation fund does not currently address this gap. Furthermore ICAEW only stipulates that firms should buy run-off cover for two years, rather than

the more usual six years. Notaries are not required to buy run-off cover at all. Some notaries continue to pay the premium on their professional indemnity insurance policy after they have ceased practising in order to provide run-off. However, this is optional. Consumers who have probate or conveyancing work carried out by a notary would therefore not have the same protections as if they had used another type of lawyer such as a solicitor. On the other hand, Bar Mutual provides cover to retired and deceased barristers for as long as Bar Mutual continues to provide professional indemnity insurance to the self-employed Bar as a whole.

Legal Ombudsman financial limits for compensation

- 5.25. Under the Legal Ombudsman Scheme Rules the maximum limit for compensation is now £50,000 (increased from £30,000 from February 2013). This level of compensation is only likely to be awarded where a consumer can clearly demonstrate direct financial loss.⁴⁶ By accepting a decision made by the Ombudsman, a consumer gives up their rights to other remedies. In practice, this could mean that although the Ombudsman finds that a significant sum has been lost (say £100,000), they can make a maximum award of £50,000. The consumer would then not be able to go to court to try to recoup the remaining £50,000 or a portion of this. Therefore if a consumer has lost a significant sum of money they may need to turn to other options to try to obtain redress. In the financial years 2011-2013 the Legal Ombudsman resolved around 110 cases with a financial remedy of over

⁴⁶ Legal Ombudsman, *A Guide to our Revised Scheme Rules*, p. 3.

£10,000. There were 17 cases resulting in an award of over £20,000 in the last financial year.⁴⁷

Low cost or free legal advice

- 5.26. An emerging risk which has been identified by a number of stakeholders are organisations currently giving free advice, so-called 'special bodies' such as Citizens Advice Bureaux, which may be able to charge for the advice they give from April 2014. At the moment professional indemnity insurance is not mandatory for some special bodies, such as charities. Of course individual organisations may choose to take out their own insurance nonetheless. Still, this gap does raise the possibility that consumers could be put at risk where protection is not in place.
- 5.27. Currently solicitors employed in non-commercial advice organisations must have 'reasonably equivalent' cover to what is required by the SRA Indemnity Insurance Rules and if they handle client money the SRA Accounts Rules apply.⁴⁸ Barristers may also provide advice in Legal Advice Centres. It is the responsibility of barristers providing such services to ensure they are either adequately covered by their own insurance policy or under a policy taken out by the organisation where they are providing the services. The BSB is gathering information on barristers working in Legal Advice Centres to find out more about this issue.
- 5.28. If an organisation does not renew their insurance or buy run-off cover and a consumer makes a claim when the

policy is no longer in force, cover may not be provided. This could have an impact where a consumer does not discover something has gone wrong for a period of time. The Legal Ombudsman has provided evidence of a case where this happened, and although the Ombudsman made an award there was effectively no insurance policy in place which the consumer could claim against. As the law centre in question had entered administration the consumer was left with no way of recouping the money they were owed.

- 5.29. The LSB is planning to end the transitional period for special bodies. This means special bodies will need to apply to a licensing authority and become regulated, and this will include having compliant financial protections in place. There may be certain anomalies in terms of the financial protections provided by special bodies which will need to be addressed before this can happen. For example, unlike SRA qualifying insurance, any insurance cover provided is currently unlikely to cover awards made by the Legal Ombudsman.
- 5.30. Furthermore, it may be that special bodies would contribute to the compensation fund of a licensing authority. However, it would be challenging to base this on turnover, for example, as special bodies do not operate in the same way as commercial firms. This raises questions about how special bodies could contribute fairly to some of the existing compensation arrangements, and underlines the need for more risk based contributions from all those who are levied.

⁴⁷ This refers to the total remedy amount, which may include repayment of fees and other forms of resolution, and not just compensation payments.

⁴⁸ See the Legal Services Board consultation on *Regulation of special bodies/non-commercial bodies*, July 2012, and the Law Centres Network response to this consultation, July 2012.

Unregulated legal advice

- 5.31. This research has addressed the issue of regulators' financial protection – unregulated legal advice has been outside the scope of this project. However, there is evidence that consumers do not distinguish between regulated and unregulated advice. Research carried out by the SRA found consumers were unaware that some legal services are not regulated and they did not know how to tell the difference between regulated and unregulated providers.⁴⁹ Our own focus groups found that consumers expect there to be some protection in place when using legal services and do not really distinguish between different types of lawyer. Meanwhile, the Legal Ombudsman received 839 complaints in the financial year 2011-12 which were out of their jurisdiction.⁵⁰
- 5.32. Although there may be protections in place when using unregulated providers – for example members of the Institute of Professional Will Writers must have at least £2 million professional indemnity insurance cover⁵¹ – there may also be no protections in place. Yet it seems that consumers expect protection and may not realise when they are choosing a provider with lower or no arrangements in place.

⁴⁹ Solicitors Regulation Authority, *Consumer attitudes towards the purchase of legal services*, February 2011, p. 7.

⁵⁰ Europe Economics report for the Office of Fair Trading, *Economic research into regulatory restrictions in the legal profession*, January 2013, paragraph 6.45.

⁵¹ See <http://www.ipw.org.uk/public/use-an-institute-member/>.

Accessibility and ease of use

- 5.33. Financial protections should be accessible to users who need them, and it should be clear how to use them. The Panel has found mixed outcomes when assessing the current arrangements against this indicator. Our assessment is based on desk research rather than road-testing with consumers through research. We are not aware of any previous research of this kind, although the SRA is currently looking into the experiences of consumers who were using law firms which were intervened in.
- 5.34. Consumers will have different entry points to the protections depending on the nature of the issues giving rise to a claim and who discovers it. We describe these in turn below.

Emergencies

- 5.35. In cases of emergency, such as fraud or business collapse, where discovery is by the regulator, access is quick and straightforward as the consumer will be notified directly. Where a consumer discovers the problem, there should be clear information about where to go. Frontline advice agencies and intermediaries such as redress schemes should also have this to hand.
- 5.36. There are examples of good practice. The SRA website has pages aimed at consumers, and these include information on how and when to report a problem to the SRA. ICAEW has submitted (as part of their application to the LSB) plans to provide a recommended standard paragraph that firms can use to make sure consumers are informed about compensation arrangements from the start of an engagement. Notaries must use a standard wording, which all consumers are given when using the services of a

notary, and which explains how to complain if something goes wrong. This prescribed wording is a requirement of the Notaries Practice Rules.

Other situations

5.37. In other situations, such as where misconduct is suspected, the route which a consumer should take is not always obvious. When the Legal Services Act reforms were designed, the Legal Ombudsman was intended to act as a single post box for all types of complaints as it was acknowledged that consumers would struggle to distinguish between service and conduct complaints. Instead, the Legal Ombudsman would receive all complaints and refer misconduct out to the approved regulators. However, as misconduct remains the operational responsibility of the regulators their websites also invite consumers to complain to them directly in misconduct situations. As set out recently by the Panel in our report on empowering consumers, the approved regulators go about doing this differently and this has created scope for confusion.⁵² A report by the Office of Fair Trading (OFT) also found continuing consumer confusion around where to lodge a complaint about a legal services provider.⁵³

Dealing directly with insurers

5.38. On some occasions the consumer will wish to approach the indemnity insurer directly. This necessitates first knowing that there is such an insurer and then finding out who it is. Lawyers accused of misconduct may be unwilling to give

details of their insurer to consumers. The Panel was not able to find publicly available information on whether this course of action is likely to be effective, although some stakeholders claim that insurers prefer to settle justified claims rather than engage in prolonged wrangling. However, in order to settle a claim a consumer would have to show causation, which is likely to be difficult in practice.

Efficiency

5.39. Consumers should not have to wait lengthy periods to obtain redress, particularly where large sums of money are involved or where a consumer needs to access funds quickly, for example to ensure a house purchase can be completed. It was extremely difficult to find out whether or not the current financial protections move swiftly. A study carried out for the Ministry of Justice in 2006 noted the time taken to settle claims for dishonesty. For the Law Society 80% of claims were settled within one year, with 100% being settled within 4 years. The CLC showed the same pattern.⁵⁴ However, this information is now quite old and things may have changed – the solicitors compensation fund, for example, is now administered by the SRA rather than the Law Society.

5.40. Where the financial protection arrangements are engaged, disruption to the consumer should be minimised. When the SRA intervene in a firm, for example, they appoint intervention agents who contact clients with urgent work left outstanding. The SRA also arrange for files to be stored and consumers are able to contact the SRA

⁵² Legal Services Consumer Panel, *Empowering Consumers Phase One Report*, March 2013, pp. 27-29.

⁵³ Europe Economics report for the Office of Fair Trading, *Economic research into regulatory restrictions in the legal profession*, January 2013.

⁵⁴ Price Waterhouse Cooper, *Financial Analysis on Compensation Fund Options for the Legal Services Sector*, June 2006.

to retrieve their files. This is important, as otherwise documentation may be lost. Where needed, intervention agents may also direct consumers to the SRA compensation fund.

Transparency over the decision making process

- 5.41. Transparency over how decisions are made is key to ensure that all claimants are treated fairly. Arrangements should be open to scrutiny by all stakeholders.
- 5.42. Regulators' compensation funds are discretionary in nature and in most cases the consumer will need to pass some sort of test, such as a hardship test, in order for a grant to be made. Although information on compensation funds is made available, most notably by the CLC in the Compensation Fund Operating Framework, and by the SRA in the consumer section of their website, the Panel considers that overall this information is not easily accessible. In particular it is not always clear how grants are decided due to the various subjective criteria which are taken into account when making a decision, if indeed these criteria are published at all.
- 5.43. Data on claims made and grants paid out is available in annual report accounts data, and in the case of the SRA is published in quarterly reports. Other than the SRA reports, data was not easy to find, and breakdowns showing the number of claims made, those accepted and rejected, or how much was typically paid per claim was not published.
- 5.44. In general we did not find evidence of accountability or assessment of whether schemes are meeting their objectives. Indeed, other than relatively vague or high-level references to protecting consumers, it was difficult to

find clear objectives for many of the financial protection arrangements. For example we were not able to find out long it might take for a claim to be settled, nor did we find evidence of objectives around the length of time it typically should take.

- 5.45. Arrangements in other sectors however do set out objectives. The Financial Services Compensation Scheme (FSCS), for example, aims to:
- “respond quickly, efficiently and accurately to consumer claims for compensation;
 - raise public awareness of the protection provided by the FSCS;
 - ensure that FSCS operates as cost-efficiently as possible and maximises recoveries from the estates of failed providers and third parties;
 - be ready to respond to defaults in the financial services industry to protect consumers and financial stability;
 - enhance the capability of the FSCS by enabling the people who work for us to develop their skills, knowledge and professionalism.”⁵⁵
- 5.46. It would be useful if the financial protection arrangements in the legal services sector set out broad objectives and key performance indicators, which could then be used to assess whether or not the arrangements are delivering against their objectives. Performance indicators could include accessibility of schemes for consumers, publication of data, and target time taken to respond to claims.

⁵⁵ See <http://www.fscs.org.uk/industry/about-the-fscs/organisational-information/mission-and-aims/>.

Independent governance

- 5.47. Not reviewed as LSB already assesses compliance as part of the Internal Governance Rules (IGR) process.

Information sharing

- 5.48. As there are a number of different actors in the area of financial protection it is desirable that they are able to join up and share information easily. This may aid detection of issues before they become a problem. And it could help to make sure action is taken when a problem is discovered.
- 5.49. The SRA Qualifying Insurers Agreement contains reporting obligations – an insurer must inform the SRA if, for example, the insurer becomes aware of dishonesty or fraud on the part of the firm, if premiums or excess are not paid, or if the insurer reserves their position because they are investigating circumstances which could lead to a claim. The SRA also has the power to ask insurers for information about any insured firm. In 2012 the SRA received 67 notifications under clause 6 of the Qualifying Insurer's Agreement.
- 5.50. In theory this should give the SRA information which could lead to early detection of any problems with a firm. However, in practice some stakeholders complained that when they do report concerns, action does not appear to be taken. One qualifying insurer told us that although they are occasionally asked if they have information on whether a firm is insured or not, they have so far never had any questions about any firm's claims history. There was also agreement that when action was taken it was much too slow, allowing dishonest or

incompetent solicitors to go on practising.

- 5.51. The SRA minimum terms and conditions also provide that where an award is made by the Legal Ombudsman which is not met by the firm, it must be covered by the relevant qualifying insurer. Some stakeholders raised concerns that the Legal Ombudsman may also make awards in relation to poor service, and insurers now have to cover these claims in some cases, although service quality is not something they have covered in the past. There is some resistance to this, for example one respondent to the Legal Ombudsman's consultation on changes to the Scheme Rules (an insurer) said they "contest any order of compensation above the value of £20,000".⁵⁶
- 5.52. Banks also hold valuable information about firms' creditworthiness and the risk of them having to close suddenly. One bank has told us that data protection rules prevent them sharing this information with regulators. However, this is clearly unsatisfactory from a consumer perspective and contrasts with the information regulators can extract from insurers. The difference is that regulators have greater leverage over insurers by setting minimum terms and conditions. This issue needs to be explored further.
- 5.53. There is a basic exchange of information between the BSB and Bar Mutual. There is no system for sharing information between the BSB and general market insurers. If the BSB becomes a regulator of entities they may set out minimum insurance terms that entities will be required to meet, which would likely be similar to the

⁵⁶ Legal Ombudsman, *Scheme Rules revision*, November 2012, p. 22.

SRA's arrangements. Notaries are not required to inform the Faculty Office of any claims made against their insurance policy.

- 5.54. There are Memoranda of Understanding in place between the Legal Ombudsman and the Approved Regulators, which provides an opportunity for information sharing. However, when the Ombudsman refers a consumer to an indemnity insurer or a regulators' compensation fund they do not collect information on whether the consumer is able to obtain redress. Therefore it is not always possible to tell what the outcome of a complaint is.

Arrangements are risk based

- 5.55. Finally, the Panel considers arrangements should be risk based, meaning providers who pose a higher risk contribute more to protection arrangements than those who pose a lower risk. In practice this means the incentives of legal services providers will be better aligned with those of consumers, as those providers who have the best systems and controls in place will pay lower premiums towards protection measures.
- 5.56. Those lawyers who currently purchase professional indemnity insurance in the open market (including arrangements which use qualifying insurers and/or minimum terms and conditions) already have incentives in place to demonstrate good risk controls. Insurers we spoke to as part of this project explained that they look at various indicators when setting premiums, such as disciplinary and complaints records, the number of fee earners, the fee earner to support staff ratio, and the type of work carried out, as well as the claims history. Those who specialise in one type of work (even if it is higher risk from the

perspective of high value claims being made, such as conveyancing), were considered to be a better risk.

- 5.57. Currently we have not found a great deal of evidence of differentiated pricing in compensation funds, beyond holding of client money. Solicitors, for example, pay either £92 for an individual or £1,340 for sole practitioners or recognised or licensed bodies holding client money. This means that solicitors cannot reduce their contributions to the fund, unless they do not hold any client money.
- 5.58. The CLC operates a more differentiated scale. In 2012 the minimum fee was £500 for firms with a turnover of £100,000 or less, rising to £9,600 plus a proportion of turnover for those firms whose turnover exceeds £3 million. However, although these contributions are based on the size of turnover, they are not particularly reflective of risk either.
- 5.59. The Notaries Society told us that notaries used to make higher contributions to the Notaries Guarantee fidelity scheme in the past if they held client money. However, this created higher administration costs and ultimately was not worthwhile. Therefore all notaries now pay the same. Holding client money was not considered to be a particular insurance risk as dishonesty does not only involve stealing from client accounts.

Cost-effectiveness

- 5.60. The financial protection arrangements are one of the major costs the profession has to bear, and one which consumers ultimately pay for. It is important that costs are proportionate to risks, and that artificial barriers to entry or exit are not created by

provisions like contributions to compensation funds or run-off cover.

- 5.61. Currently, overlaps between arrangements may be creating inefficiencies, which could increase the cost of providing the protections, as administration costs of current arrangements may be duplicated. Information on administration costs has not been easy to find. However, it seems these costs are not insignificant. The CLC Annual Report 2011, for example, notes that administrative expenses for the compensation fund in 2011 were £108,049.⁵⁷
- 5.62. The cost of carrying out interventions is also increasing. The SRA effected 37 interventions into firms in 2012. However, there are reports that the numbers of law firm insolvencies is increasing and the SRA committed £2.2 million to interventions in the first quarter of 2013. This is almost £1 million more than it spent on interventions in the whole of 2012.⁵⁸ In 2011 the CLC details costs of £46,576 relating to interventions, although data on the number of interventions effected was not available.⁵⁹
- 5.63. The rising cost of interventions has led the SRA to call on law firms to have contingency plans for insolvency. The regulator has also said it is likely to use the compensation fund to cover the cost of interventions as it is “more suitable to cover ‘one-off peaks’ in spending”.⁶⁰ Such large one-off costs

could have an impact on the fund however, with knock-on effects for consumers. The SRA is currently consulting on this option. One alternative option could be for the SRA to take a ‘deposit’ from opening firms which could be held against the cost of interventions, then paid back to firms closing in an orderly manner, to set off against the cost of run-off premiums.

- 5.64. A study carried out for the Ministry of Justice in 2006 modelled the costs of different compensation fund options. The study examined various scenarios, including one centralised fund, one centralised fund but excluding solicitors who would keep their own separate fund, and a variation of the existing arrangements, whereby each regulator has its own fund. Broadly, the study found that a single compensation scheme would be more cost-effective and have more stability in terms of the levies on the profession.⁶¹ It is likely it would also be more consistent across all types of lawyer, and be clearer for consumers.
- 5.65. Due to the size of the solicitors compensation fund, it was thought the savings made by solicitors if a single scheme were to be set up would be lower than savings for other types of lawyer (although savings would still be made). The cost-effectiveness of a single scheme was also thought to be lower for the Bar and some lawyers undertaking certain lower-risk areas of work such as patent and trade mark attorneys. These might benefit more by keeping their existing arrangements. However, with the introduction of BARCO, it is not certain that the risk profile remains the same as when the study was carried out. Overall, the

⁵⁷ Council for Licensed Conveyancers Annual Report 2011, p. 7.

⁵⁸ See <http://www.lawgazette.co.uk/news/prepare-worst-sra-tells-struggling-firms>.

⁵⁹ Council for Licensed Conveyancers, Annual Report 2011, p. 14.

⁶⁰ See <http://www.legalfutures.co.uk/latest-news/sra-paints-grim-picture-financial-instability-among-law-firms> and <http://www.lawgazette.co.uk/blogs/blogs/news-blogs/sra-right-raid-compensation-fund-now-least>.

⁶¹ Price Waterhouse Cooper, *Financial Analysis on Compensation Fund Options for the Legal Services Sector*, June 2006.

complexities of transitioning to a single scheme were considered to be high.⁶²

5.66. This possibility should be examined in more detail, but lack of transparency over costs is a real concern. The forthcoming LSB project on the cost of regulation could examine this further.

⁶² Ibid.

6 Alternative options

6.1. The options above set out the current financial protection arrangements and suggest making changes such as setting key performance indicators and greater publication of data. However, as part of the advice request we were also asked to consider alternatives for delivering effective protection. For example the LSB specifically requested advice on the likelihood of consumers being willing and/or able to insure themselves against some or all of the risks they face. We were also asked to comment on whether consumers assume there are regulatory arrangements in place and that therefore there is no risk attached to choosing an advisor. Below we set out our views on these issues and some more radical alternatives to the current arrangements.

The division of risk

6.2. The Panel is separately publishing a paper which examines the issue of consumer responsibility across the spectrum of legal services regulation. The comments below relate to financial protection arrangements only.

6.3. Based on our research we are strongly of the view that consumers should not have to take on more risks than they do at the moment. Even if they could not describe the current regulatory arrangements exactly, consumers in our focus groups were clear that they expected some protection to be in place. Lawyers are seen as professionals, and as such consumers

expect there to be some sort of framework in place through which they can seek redress.⁶³

6.4. Our focus groups found no evidence of disengagement from the decision-making process however. Consumers did not make lazy decisions because they felt they would be protected from any unwelcome consequences by regulations. On the contrary, consumers have less information about the service provided than lawyers, and they are aware of this knowledge gap.

6.5. Moral hazard only applies when it is possible for buyers to assess the quality of service or where credible signals can be seen before the transaction takes place (for experience and credence goods). Legal services are recognised as being an area with high information asymmetries, and where buyers are not able to judge the quality of advice. This can be exacerbated by difficulties in assessing quality even some time after the advice has been given.⁶⁴

6.6. Our focus groups showed that in a situation where consumers were forced to look for protections themselves, participants said they would only look for firms who advertised that they had insurance in place, so sending out a signal of credibility. Indeed, people said a lack of insurance would undermine their confidence in the profession.

⁶³ Vanilla Research, *Risk and the role of regulation*, February 2013, p. 10.

⁶⁴ Charles River Associates report for the Solicitors Regulation Authority, *Review of SRA client financial protection arrangements*, 2010, pp. 31-34. Also see Ministry of Justice, *Full Regulatory Impact Assessment, Legal Services Bill*, 2006.

6.7. Moreover, consumers were well aware of the costs of having to seek redress – in time and stress, as well as possible financial losses. Consumers chose lawyers with the aim of avoiding such problems, primarily by relying on recommendations, previous experience or Internet searches. In view of the information asymmetries mentioned above, they hope these strategies will increase the likelihood of them receiving good quality advice rather than in the expectation it will ensure it.⁶⁵

Consumers self-insure

6.8. The focus groups probed whether consumers would be willing to take out their own insurance policies. This idea was rejected by participants. Getting legal advice is already seen as stressful, happens infrequently, and is usually in the context of important personal situations. Consumers already felt they had trouble making informed decisions about lawyers, and they wanted to avoid having to make additional choices about insurance policies at the same time.

6.9. Moreover, unlike when buying car or house contents insurance, they were also unsure of what risks they would need to insure against in the context of legal advice.

6.10. They also thought:⁶⁶

- It would prove more expensive;
- It might not be independent;
- It would not widen consumer choice (because in practice consumers would only look for those providers who offered their own insurance,

thus it could actually have the effect of restricting choice);

- Some people had a problem with the idea itself, considering that lawyers are paid to provide expert advice and so consumers should not have to protect themselves from mistakes.

6.11. Under these circumstances, we consider it is unlikely that if there were no mandatory protections consumers would end up segmented into those who buy their own bespoke legal insurance for each transaction and those who don't. Instead, it is more likely that those more able to inform themselves would search for credible quality signals – in this case lawyers who advertise that they have bought their own insurance and so are covered. On the other hand, more vulnerable consumers are likely to either not know that they should look for this signal, or may take risks in order to pay lower prices by choosing lawyers who do not have insurance.

6.12. This would result in those who are better able to protect themselves not actually having to because they would only shop with insured lawyers. Without mandatory financial protections, universal coverage would be lost however. At the same time vulnerable consumers could end up with no protection at all.

6.13. It would be inefficient to expect consumers to buy cover themselves each time they conduct a legal transaction. The regulatory input which would be needed to inform and educate consumers, and the use of nudge techniques to try to ensure consumers buy cover, would be extremely high. Therefore a mandatory scheme which ensures all consumers who suffer detriment are covered is preferable.

⁶⁵ Vanilla Research, *Risk and the role of regulation*, February 2013, p. 12.

⁶⁶ Vanilla Research, *Risk and the role of regulation*, February 2013, pp. 20-21.

- 6.14. Moreover, it needs to be recognised that the party causing risk is the solicitor not the consumer. Consumers should not be asked to source insurance themselves – a more efficient solution is for the insurance to be between the insurer and the legal advisor. By asking legal practitioners to buy their own insurance, insurers are able to charge based on the individual risk profile of a firm.
- 6.15. Although consumers may be able to purchase their own insurance in certain circumstances, for example to cover a conveyancing transaction,⁶⁷ there are other circumstances where consumers will not be able to insure themselves. Indeed, one of the insurers we interviewed indicated that they would be unlikely to foresee a situation where they would be willing to underwrite this type of insurance since they would not know who the consumer was taking advice from and therefore would be unable to calculate the risks involved.
- 6.16. Furthermore, several interviewees pointed out that if a professional adviser was found to have breached their duty of care to a client, then their insurance should meet a claim. Consumers self-insuring might negate the need for lawyers to take responsibility for their actions. On the other hand if negligence could not be proved then it is unlikely a 'self-insuring' policy would pay up. In addition, it would be likely that before insurers made payment they would want the claimant to have pursued any possible claim against the legal advisor (or they would at the least seek subrogation rights to enable them to pursue it in their place).
- 6.17. In this scenario consumers could become a proxy for insurers to tell the difference between high risk and low risk legal advisors – but consumers would not reliably be able to tell the difference due to genuine information asymmetries. All that the insurers would be able to do is to charge all consumers the same price (reflecting an average risk profile) and this would, amongst other things, allow unfair cross-subsidisation of poor quality advisors, since an average charge would not distinguish between high and low risk providers.
- 6.18. In addition to this, besides the risk of consumers not being covered at all, there is also the risk of consumers being pushed into a position where they feel they should pay too much for insurance (a good recent example of this is payment protection insurance) due to the level of emotion often involved when using legal services.
- 6.19. Cover should be the same for all legal advisors (because uniform universal coverage is considered the optimal outcome for consumers). However, since the source of risk resides with the advisors themselves and not with the consumers, risk-based pricing by insurers incentivises higher quality standards so that firms are able to pay a lower price for their mandatory insurance.
- 6.20. Otherwise, consumers would have to find out what insurance each advisor or firm has bought, what is covered (and what is not) and have to make a decision based on this. All of this adds to the transaction costs with no discernible advantage in terms of market outcome, only risks for consumers in terms of 'bad' purchasing decisions. Minimum terms and conditions are optimal as this maintains competition between insurers and

⁶⁷ See the Home Owners' Protection Policy (HOPP) for example.

means prices to practitioners are based on risk, while still maintaining a basic level of cover.

Holding client money

- 6.21. Some stakeholders consider client accounts to be a particularly high risk, while others thought less so. Insurers, for example, tended to focus more on liabilities stemming from negligence. However, regulators have detailed rules around holding client money and put a great deal of resource into monitoring and enforcement in this area. The Law Society is currently scoping the possibility of making client accounts for solicitors optional, while the SRA is undertaking a conveyancing review which includes looking carefully at client accounts.
- 6.22. In some cases stakeholders told us that solicitors find client accounts useful. For example, large law firms use them to conduct international transactions. In other cases lawyers need to hold client money due to existing processes, for example in a conveyancing transaction. Estimates of the average figure held in a solicitor's client account at any one time range between £1.5 million and £2 million. On the other hand sometimes client accounts are not needed – for example where firms deal exclusively with criminal cases which are funded by legal aid, the lawyer has no need to hold client money.
- 6.23. In some cases the use of escrow accounts could be a possibility, either to reduce the holding of client money by law firms, or to remove it entirely. This option is currently being developed by both the Bar Council and IPS. The idea holds a number of attractions for providers, for example annual auditing would be outsourced to the escrow company, providing a benefit for sole practitioners. Escrow schemes may remove a major source of risk and so could cost less than current protection arrangements. Barristers currently pay BARCO 2% of the case fee subject to a cap of £250 per transaction.
- 6.24. For consumers the major benefit is that money put into the escrow by them is held for a particular purpose and may not be released without their consent. When money is deposited with BARCO the barrister and the client have to agree what the money is for. Each time money is withdrawn (except for court fees) authorisation is needed from the client. For low value transactions the client is notified and if no queries have been raised after five days the money is paid out. For higher value transactions both sides must authorise the payment before the money is released.
- 6.25. Although escrow accounts are not without risk to the client themselves, for example from theft from the account provider, this is thought to be less likely than when client money is held by individual providers. BARCO does not have a compensation fund but is itself insured through the open market so that redress can be paid if needed. In addition, the consumer is protected by the Financial Services Compensation Scheme (subject to the limit) and can also complain to the Financial Ombudsman Service.
- 6.26. However, escrow accounts are unlikely to be possible in all circumstances, for example where a lawyer is managing the affairs of someone who is ill or incapacitated, the possibilities of an escrow account will be limited since it is the lawyer giving consent for the money to be paid out.

A single scheme

- 6.27. An alternative option to the current arrangements would be a single entity to oversee financial protections across the sector. This could be responsible for setting minimum terms and conditions applicable to all legal advisors purchasing professional indemnity insurance. Qualifying or participating insurers could then sign up to the minimum terms, as per the current SRA model. This would allow insurers to compete with one another for business, while assuring a minimum level of consumer protection.
- 6.28. A single scheme would potentially allow all legal service providers access to the same insurers, and all providers would have cover based on their individual risk profile. This would have the effect of separating the financial protections from professional title, which is how they are currently organised. Instead providers would be incentivised to have good risk and quality controls in place based on the activities they carry out, and completely divorced from their professional title.
- 6.29. Further advantages of having a single scheme would be that consumers would have one point of contact for all problems, data could be collected and analysed in one place, and the cost to the legal profession could potentially be lower since a single scheme could save on duplicating administration costs. Intelligence could be shared between the scheme and the regulators in terms of monitoring (for example by cross-checking those with practising certificates against those with insurance), as well as where enforcement action might be needed (for example where a firm has a high number of claims made against it).
- 6.30. As it is not possible for individuals to take out insurance against their own dishonesty, it is likely that such a scheme would also need to run a compensation fund. This could be administered in the same place, and would have the advantage that data from the insurance market and the compensation fund could be brought together. Again, there would also be a single point of contact for both consumers and lawyers. A single compensation fund would also raise the possibility of more risk-reflective contributions from members.
- 6.31. Of course any such scheme would need to be carefully scoped to determine viability. It would need the right governance arrangements and different branches of the profession would need assurance that one part was not cross-subsiding another. However, although the costing would need to be properly modelled, there is some evidence to suggest this approach could be more cost-effective overall. The study carried out for the Ministry of Justice in 2006 found that overall a single compensation scheme would be more cost-effective, have more stability in terms of the levies on the profession, and be more consistent across all types of lawyer, than individual schemes, although with some caveats.⁶⁸
- 6.32. Finally, it is important to note that this review has focused on regulated providers of legal advice. Other research has found that consumers do not tend to distinguish between regulated and unregulated providers, but instead often think that they will be protected whenever they obtain advice. Of course this is not the case in reality,

⁶⁸ Price Waterhouse Cooper, *Financial Analysis on Compensation Fund Options for the Legal Services Sector*, June 2006.

and it may be that any further work in the area of financial protections should look at this in greater detail. The LSB's forthcoming project on general legal advice may provide a place to examine this issue. The type of centralised arrangements described above would potentially allow unregulated advice providers, and providers such as claims management companies, who are about to come within the jurisdiction of the Legal Ombudsman, to come under the financial protection umbrella.

7 Conclusions

Current arrangements

- 7.1. At a high level, on most occasions the financial protection regimes will deliver redress against each of the key risks that consumers face when buying legal services. They are designed to offer a comprehensive level of protection and assume that consumers should bear quite a low burden of risk – we consider this is entirely appropriate given the nature of legal services, consequences of the risks transpiring, and the difficulty consumers face in preventing loss.
- 7.2. Such a regime comes at a high cost, but the evidence shows that consumers greatly value the protection offered and are willing to pay for it. However, it is quite possible that the same level of protection could be delivered more cheaply if the system was organised differently. This paper has explored two alternative options – de-risking the system through a different approach to handling client money and establishing a single financial protection regime – that should be looked at further. However, we reject the option that consumers should be invited to take out their own insurance. Lawyers are the source of the risk, not consumers. Consumers are badly placed to source their own cover and it is likely that while informed consumers would use insured lawyers, other consumers would not.
- 7.3. Looking at the regimes in detail the Panel has identified a series of issues, concerns and areas for improvement. These include scenarios where

consumers may unfairly lose out due to gaps in coverage, disputed territory between regulators and insurers and issues related to the discretionary nature of schemes. In addition, the protections can be difficult to access, fragmented and lack transparency.

- 7.4. The following areas require action:
- Gaps – there are some policy issues that need to be resolved to offer greater certainty for consumers, e.g. around aggregating claims, unrated insurers and special bodies.
 - Data collection – in general we found it difficult to find and compare data in order to assess the arrangements which are in place. Data should be more easily accessible. It would be useful if data were collected and published in one place. This would help with intelligence gathering for enforcement purposes, and could inform more risk-based analysis of the market.
 - Accountability – it would be useful if schemes, particularly compensation funds, set performance indicators and assess whether or not these are being met. This would help administrators review the protections and check whether they are delivering their objectives or not.
 - Transparency – the Panel found the way compensation funds in particular operate was not very transparent. Data was either not available or fairly high level. The

discretionary nature of compensation funds raises basic issues of fairness. It is not acceptable, for example, that where there is a cap on the total amount a fund can pay out in a year, those consumers who are unlucky enough to claim 'last in the queue' simply end up with nothing. There are also dangers around the use of hardship tests and asking consumers to exhaust other options before allowing them to claim on the fund. These concerns could be addressed through greater openness in how funds operate and clearer criteria, for example on how hardship tests may be met.

- Information sharing – channels appear to be in place in theory but it seems best use is not being made of these. Different organisations such as indemnity insurers collect information which could be invaluable to regulators. We recommend closer working between these groups. For example, at renewal, solicitors' firms can ask insurers for a summary which shows their claims history. It might be possible for the SRA to also have access to this form when lawyers are renewing their practising certificates. This would help to inform the regulators' enforcement work, providing protection for consumers before a problem arises. There should be effective channels for information sharing between regulators, especially where two regulators might be involved – such as when notaries or chartered legal executives also work in solicitors firms.
- Risk based charging – a greater emphasis on charges and levies based on risk would truly mean the

polluter pays, as those firms more likely to cause damage would have to pay higher premiums. Although this is currently the case with firms buying professional indemnity insurance in the open market, more thought could be given to risk reflective pricing when setting compensation fund levies.

Recommendations

The Panel's advice to the LSB is as follows:

- Financial protections should remain mandatory.
- Consumers should not be asked to source their own insurance.
- Approved Regulators should be required to collect more comprehensive data on financial protections, especially in relation to compensation funds. Data should be published in an accessible and timely manner.
- A set of key performance indicators should be developed for compensation funds, and assessment should then be made against these.
- The discretionary nature of compensation funds should be examined in greater detail, and research should be carried out with consumers who have gone through the process of making a claim.
- The LSB should encourage greater openness and joined-up working between Approved Regulators, the Legal Ombudsman and other actors in the financial protection field:
 - This could include the introduction of formal processes for information sharing between Approved Regulators themselves (such processes are already in place between regulators and insurers, as well as between regulators and the Legal Ombudsman).
 - Existing information sharing channels should be used to better effect to improve intelligence gathering and any subsequent enforcement action.

This would help to stop problems before they reach the stage where financial protection measures are needed.

- As part of the LSB's work on general legal advice we recommend attention is paid to the financial protections in place (if any) for those using unregulated providers. In particular, the Panel is concerned about the potential detriment to consumers when protections are not in place, or not adequately enforced.
- Finally, we strongly recommend that the idea of centralised protection arrangements for all regulated legal advice providers is fully scoped, with attention paid also to the possibility of bringing unregulated providers (or those who currently have no financial protection arrangements) under the same umbrella.

Annex 1 – LSB request



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1 October 2012

Dear Elisabeth,

Consumer Panel – Financial Protection Arrangements

Our Business Plan says that we will “*seek advice from Panel on extent to which regulators’ financial protection arrangements, including compensation, are adequate and the appropriate level of risk consumers should be expected to bear*”. This letter seeks that advice and sets out some of the types of issues that the Panel may like to consider.

Legal service transactions often involve a degree of financial risk for consumers. Such risk, in terms of loss or misuse of fees required by providers for their services or of money held on behalf of clients, may arise from incompetence or dishonesty of an organisation or individual on any individual transaction or from a broader financial or systemic failure within an organisation.

Many of the risks are mitigated through the use of insurance and compensation, usually in the form of indemnifying the provider against claims made by the client or, where insurance won't pay, a fund to compensate the loss. Some of these arrangements also serve to protect the wider trust the public has in lawyers and/or to ensure that related consumer interests in other markets are also protected (for example the SRA can use money in its compensation fund to bridge funding gaps for residential conveyancing where client money has been frozen as part of an intervention).

The Legal Services Act 2007 requires Approved Regulators (and Licensing Authorities) to have appropriate insurance and compensation arrangements as part of their regulatory arrangements. The LSB has to consider the appropriateness of these arrangements when considering applications for both changes to regulatory arrangements and from new regulators. As many such arrangements have been in place for several years, it is the Board's preliminary view that the current regulatory solutions for

meeting these risks may not necessarily reflect a good current understanding of what is an appropriate level of consumer risk. We believe that advice from the Panel will be able to help both the Board and current and potential ARs reflect and, if necessary, act on this issue.

We are also concerned that consumers may take false confidence from the very fact that there are *some* regulatory arrangements in place and assume that all legal transactions take place in a 'zero risk' environment. That in turn may lead them to be less discerning about the type of adviser they use, and, as a result, end up taking more risks than they might with other significant transactions (for example investment decisions). Again, we would welcome the Panel's advice on whether this is a real or only theoretical risk and, if the former, how it might best be mitigated.

In order to meet these requests, the Panel may need to consider:

- the types of risk faced by consumers and how these vary by type of legal service, provider or transaction (for example when a problem may not come to light for several years);
- any evidence on how consumers assess and respond to risk in legal services transactions and the role of their perception of regulatory protection within that (perhaps with reference to other markets, notably financial services);
- the likelihood of consumers being willing and/or able to insure themselves against some or all of the risks they face (if the insurance market developed appropriate products);
- possible approaches for delivering effective protection and the advantages and disadvantages for consumers with them, both within the current broad regulatory architecture of insurance and fund arrangements and beyond it.

We would like the advice to particularly consider the risks facing individual consumers, as such consumers may have less ability to adequately understand the risks that they face in legal transactions. However, you will be aware that other consumers and third parties, such as banks and financial institutions, may also rely on regulatory financial protections and any views you have on this would be welcome.

For the avoidance of doubt, we do not see fee levels and consumers challenging bills or compensation for redress awarded by the Legal Ombudsman as within the scope of the requested advice.

The Consumer Panel is also asked to note that the SRA is undertaking a review of their compensation arrangements. The LSB considers that it is likely that the Consumer Panel's findings will be especially useful in helping inform this work and we would therefore encourage the Consumer Panel to engage with the SRA throughout the review.

Yours sincerely

Chris Kenny

Chief Executive

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Annex 2 – Overview of existing protections

Overview of current financial protections

- 8.1. Under the Legal Services Act 2007 Approved Regulators have made provision for indemnification and compensation arrangements as part of their regulatory arrangements. Section 21 of the Act sets out what references to regulatory arrangements are and includes indemnification arrangements and compensation arrangements.
- Indemnification arrangements are defined as arrangements for ensuring the indemnification of those who are or were regulated persons against losses arising from claims in relation to any description of civil liability incurred by them (or by employees or former employees), in connection with their activities as such regulated persons.
 - Compensation arrangements are fairly broadly defined and mean arrangements to provide for grants or payments to relieve or mitigate losses or hardship suffered due to negligence, fraud or other dishonesty, or failure to account for money received in connection with their activities as such regulated persons.
- 8.2. In addition to this, the Solicitors Act 1974 (amended by Schedule 16 of the LSA 2007) allows the Law Society to make rules concerning grants of compensation, establishing or maintaining compensation funds, providing indemnity, and providing redress for inadequate professional services. Finally, the Administration of Justice Act 1985 applies to the Council for Licensed Conveyancers in addition to the Legal Services Act 2007. This lays down certain requirements, including those relating to professional indemnity, compensation and insurance.
- 8.3. Although financial protection is a legal requirement, regulators also consider that such arrangements benefit the profession – both because lawyers are covered for civil liability claims and because through these protections the public should not suffer loss and so confidence in the integrity of lawyers is maintained.
- 8.4. Below we set out a brief overview of the main financial protection arrangements in place for solicitors, barristers, licensed conveyancers, chartered legal executives, and notaries, as well as a very brief overview of the work done by the Legal Ombudsman.

Solicitors

- 8.5. The SRA is the largest regulator in the legal services sector: their regulated population comprises 128,169 practising solicitors and 10,827 solicitor firms.⁶⁹ For solicitors, the rules

⁶⁹ See SRA key statistics. Figures correct March 2013.

governing financial protection are wide ranging and include various rules around indemnity and intervention powers, as well as the SRA Compensation Fund Rules.

- 8.6. There are 10 overarching SRA Principles, of which those focusing on acting with integrity, behaving in a way that maintains public trust in individuals and in the provision of legal services; running or managing businesses effectively and in accordance with proper governance and sound financial and risk management principles, and protecting client money and assets, are the most important for this project.
- 8.7. Under these broad principles are more specific rules which relate to various aspects of financial protection.
- 8.8. The SRA Accounts Rules 2011 seek to make sure that:
- Client money is safe;
 - Clients and the public have confidence that client money held by firms will be safe;
 - Firms are managed in such a way, and with appropriate systems and procedures in place, so as to safeguard client money;
 - Client accounts are used for appropriate purposes only; and
 - The SRA is aware of issues in a firm relevant to the protection of client money.
- 8.9. Additionally, the Client Protection section of the SRA Handbook contains:
- SRA Indemnity Insurance Rules;
 - SRA Indemnity (Enactment) Rules;
 - SRA Indemnity Rules;
 - SRA Compensation Fund Rules; and
 - SRA Intervention Powers (Statutory Trust) Rules.
- 8.10. The desired outcome of these rules is that clients are protected against negligence and dishonesty by firms and individuals through professional indemnity insurance and compensation arrangements.

Professional indemnity insurance

- 8.11. All firms carrying on a practice have to take out and maintain insurance. This insurance must be provided by SRA 'Qualifying Insurers', who agree to provide minimum terms and conditions which are set by the SRA. Qualifying insurers sign up to a Qualifying Insurer's Agreement which sets out these terms in detail. Qualifying insurers must guarantee to meet the minimum terms and conditions – these terms cannot be excluded or reduced in any way.
- 8.12. The minimum terms and conditions cover all civil liability arising from private legal practice in England and Wales, and there are very few exclusions. The sum insured for any one claim (exclusive of defence costs) must be, where the insured firm is a recognised body or a licensed body (in respect of its regulated activities), at least £3 million, and in all other cases, at least £2 million, on a per claim basis. Insurers are not able to avoid paying claims because facts are not disclosed or are mis-represented, or because premiums have not been paid by firms. Insurers are not liable for dishonest practitioners – this means where a

sole practitioner has been dishonest, or where all the partners in a firm were dishonest, the insurer is not liable. These claims would instead fall under the compensation fund. However, where some partners in a firm were innocent the insurer would still be on risk. Finally, insurance is offered on a claims made rather than a loss incurred basis. This means the insurer on risk is the insurer when the claim arises, not the insurer when the alleged mistake was made.

- 8.13. There are currently 24 qualifying insurers. Those with the largest market share for the 2012-13 indemnity year were XL Insurance, Travelers Insurance, QBE International Insurance and Zurich.⁷⁰ Solicitors' indemnity insurers underwrote a total of £239 million for compulsory professional indemnity insurance in 2012.⁷¹
- 8.14. Those firms who are not able to obtain cover in the open market currently go into the Assigned Risks Pool (ARP). Firms in the ARP pay a higher premium. The risk was previously divided amongst the qualifying insurers, split proportionately according to their respective market shares. This year, however, the payment of claims will be divided between insurers and the profession in 'layers' – the profession will pay the first layer of £10 million, followed by the second £10 million which will be covered by insurers, and so on, up to a total of £50 million.
- 8.15. From October 2013 the ARP will be closed and firms who cannot obtain cover will instead have 90 days extension of cover from their previous insurer. Firms have 30 days of this period to find open market cover. If they are not able to do so, during the remaining 60 days there will be a cessation period during which firms cannot accept new instructions but can continue to work on existing instructions. At the end of this period they will cease practice and their previous insurer will provide the six years required run-off cover.
- 8.16. Practitioners must buy run-off cover when firms close down, so that consumers are compensated for claims that arise after a firm has closed. The qualifying insurer that was on cover when the firm closed has to provide six years of run-off cover, starting from the expiry date of the policy. According to the Law Society about 40% of claims are made more than three years after the event.⁷² Run-off cover typically costs around 2-3 times as much as the final annual premium, so is a significant overhead for closing firms.⁷³ Under the minimum terms and conditions, where firms do not pay the run-off cover premium the insurer remains liable for the run-off cover as though the firm had paid the premium.
- 8.17. The Law Society currently provides run-off cover supplementary to the six year period for those firms which closed between 31 August 2000 and 30 September 2011. This policy will cover claims notified before 1 October 2017. The Law Society plans to extend the supplementary cover beyond 2017 and is currently in discussions with the SRA about this.⁷⁴

The Compensation Fund

- 8.18. From the profession's perspective the fund covers claims which fall outside those covered by professional indemnity insurance:

⁷⁰ See <http://www.sra.org.uk/solicitors/code-of-conduct/professional-indemnity/income/estimated.page>

⁷¹ See <http://www.legalfutures.co.uk/latest-news/new-indemnity-insurers-capture-market-share-solicitors-pay-less-cover-year>.

⁷² See <http://www.lawsociety.org.uk/advice/articles/run-off-cover/>.

⁷³ See <http://www.lawsociety.org.uk/advice/articles/run-off-cover/>.

⁷⁴ See <http://www.lawsociety.org.uk/advice/articles/run-off-cover/#supplementary>.

- Replacing money which has been misappropriated or is not accounted for, where the dishonest party was a sole practitioner or included all the partners in a firm;
 - Civil liability claims where a practitioner should have had professional indemnity insurance in place but did not;
- 8.19. The compensation fund is funded by a levy on the profession. The compensation fund contribution for the practising year 2012-13 was £92 for an individual commencing practice on or after 1 November 2012, and £1,340 for recognised sole practitioners and recognised and licensed bodies holding client money.⁷⁵
- 8.20. From the consumer perspective the fund is a discretionary fund which provides help where a consumer has:
- Suffered loss because of dishonesty, or
 - Suffered loss and hardship due to failure to account for money.
- 8.21. Consumers must apply for a grant within 12 months of the time the loss came (or should reasonably have come) to their knowledge. Grants are discretionary, and are capped at £2 million.
- 8.22. Generally, individual applicants to the fund are assumed to have passed the hardship test, while those who apply in a business capacity have to provide evidence to satisfy the test. This is especially applicable to lenders, who have made large claims on the fund in the past in connection with mortgage fraud. The Charles River Associates report from 2010, for example, recommended that consideration should be given to excluding corporations from the scope of the fund, as individual clients are in greater need of regulatory protection than institutional clients.⁷⁶

SRA reviews

- 8.23. The SRA has made major changes to the way client protection works in recent years, including changes to the Compensation Fund and the Assigned Risks Pool, which will be abolished entirely from October 2013. The SRA is also currently undertaking a comprehensive review of financial protection arrangements, the results of which are due to be published in 2014.

Barristers

- 8.24. The Code of Conduct of the Bar of England and Wales states that every self-employed barrister must be covered by insurance against professional negligence and be entered as a member with the Bar Mutual Indemnity Fund. Insurance premiums must be paid and information requested by Bar Mutual must be supplied. Bar Mutual is a not for profit company, which is owned and controlled by its members.
- 8.25. All self-employed barristers renew their cover on 1 April. Chambers receive a list of those barristers who have not completed their renewal or paid their premium, and they may be reported to their Head of Chambers and to the Bar Standards Board. Since 2012 the Bar Standards Board has also cross-checked that barristers renewing their practising

⁷⁵ See <http://www.sra.org.uk/mysra/fees/fee-policy-2012-2013.page>.

⁷⁶ CREA report p. 158. See also <http://www.sra.org.uk/conveyancing/>.

certificates have the required insurance by asking them to tick a box and make a declaration confirming this when going through the online renewals process.

- 8.26. Bar Mutual premiums are calculated by reference to fee income and to the areas of practice in which members work. The minimum level of cover is £500,000 and the maximum is £2,500,000. However, members can also buy higher limits of cover through Bar Mutual or in the open market if they wish to.
- 8.27. Bar Mutual provides cover for:
- Civil liabilities arising from a self-employed barrister's practice;
 - Defending complaints made to the Bar Standards Board;
 - Claims by solicitors for their fees under approved Conditional Fee Agreements.
- 8.28. Pupils are covered by their pupillage supervisor's policy automatically. Self-employed clerks are also automatically covered for claims under the barrister's policy, where the claim is connected with the practice of the barrister or a pupil of the barrister.
- 8.29. In terms of run-off cover, every retired self-employed barrister is entitled to a minimum of £500,000 of cover free of charge for as long as Bar Mutual continues to provide professional indemnity insurance to the practising Bar as a whole. There is also provision made for death of a barrister who was practising or retired, of six years' run-off cover at the limit pertaining at the time of death.
- 8.30. Self-employed barristers are covered by Bar Mutual even if they have not paid the fees which are due. If the Bar Standards Board considered that the level of cover was not high enough or there were gaps in provision of cover they would be able to ask Bar Mutual to modify the terms and conditions. The Bar Standards Board rely on complaints to highlight any problems – a search of their complaints database going back to 1985 using the word "insurance" revealed no complaints in respect of the size of cover. There were complaints relating to failure to pay the insurance premium to Bar Mutual – but this does not represent a risk to clients, as BMIF would continue to provide cover in any case.
- 8.31. In the year to March 2012 BMIF wrote £15 million in premiums and incurred £11 million in net claims.⁷⁷
- 8.32. Barristers are not allowed to receive or handle client money or other assets, and so risks to consumers tend to be low in this area. However, in some cases it would be useful if barristers could handle client money, for example:
- To pay court fees
 - To make arbitration payments
 - With regard to settlement monies
 - Retainers
 - Contingent fee arrangements
- 8.33. In order to allow barristers to carry out these functions a new escrow service, BARCO, which is a third party company, owned and operated by the Bar Council, has been launched. The service is independent and is regulated by the Financial Conduct Authority.

⁷⁷ BMIF Directors Report and Financial Statements for the year ended March 2012.

A tri-party agreement is made between the client, the solicitor and the barrister whereby money is deposited with BARCO and the barrister and the client have to agree what the money is for. Each time money is withdrawn (except for court fees) authorisation is needed from the client. For low value transactions the client is notified and if no queries have been raised after 5 days the money is paid out. For higher value transactions both sides must authorise the payment before the money is released. Barristers pay the BARCO fee which is currently 2% of the case fee subject to a cap of £250 per transaction. Interest is paid on the money held and returned to the client. If there is a dispute the money is frozen until an agreement is reached.

- 8.34. There is some risk of misappropriation of court awards or of fraudulent transactions but this is considered to be low. BARCO does not have a compensation fund but is itself insured through the open market so that redress can be paid if needed. In addition, the consumer is protected by the Financial Services Compensation Scheme and can also complain to the Financial Ombudsman Service.
- 8.35. BARCO is currently being rolled out. The service has the potential to make it easier for clients to work directly with the Bar, but at the same time retains high levels of protection for client money.

Licensed conveyancers

- 8.36. The Council for Licensed Conveyancers regulates around 1,100 individuals and approximately 200 firms.⁷⁸ The Code of Conduct states that regulated services should only be provided by individuals or bodies who have CLC-approved professional indemnity insurance in place. This can either be provided through the CLC Master Policy (currently there are two insurers under the Master Policy), or through another insurer, where the CLC is satisfied that the cover provided is at least equivalent to that provided under the Master Policy. In practice only a few firms have opted out of the Master Policy. The Master Policy has a limit of £2 million for one claim, plus costs and expenses.⁷⁹
- 8.37. Practitioners can also purchase a self insured excess. This will reduce the premium for the firm - but in doing so they must satisfy the CLC that they have the funds to pay claims under the excess, to ensure that such claims do not fall on the compensation fund.
- 8.38. Practitioners are required to buy run-off cover before they cease practising, by buying an insurance policy lasting a minimum of six years, although typically claims will arise 18 months to two years after the practice closes. Run-off cover is only provided if premiums have been paid. Where no insurance has been bought, or run-off cover has not been purchased, claims would fall into the compensation fund.
- 8.39. Although indemnity insurance covers some instances on dishonesty, non-disclosure, misrepresentation, and false or fraudulent claims are excluded from insurance cover, and would also fall on the compensation fund.
- 8.40. The compensation fund is a fund of last resort. It covers fraud, dishonesty and failure to account, as well as negligence. It is funded by a yearly levy on licensed conveyancers, which varies depending on the amount of claims, the amount in the fund, the underlying insurance policy, and the costs of administering the fund, as well as the turnover of the firm.

⁷⁸ CLC AR p25

⁷⁹ Marsh report, 2009, p. 15, Appendix B.

In 2012 the minimum fee was £500 for firms with a turnover of £100,000 or less, rising to £9,600 plus a proportion of turnover for those firms whose turnover exceeds £3 million.⁸⁰

- 8.41. There is potential for high numbers and/or high value claims as conveyancing is a particularly high risk area. The average amount paid out is £30,000-£40,000. Negligence claims in particular can be very complex to administer and lawyers may need to be instructed, which adds to the costs.
- 8.42. The CLC can make payments from the compensation fund where they are satisfied a person has suffered or is likely to suffer due to negligence, fraud, dishonesty, or failure to account for money. A consumer has six months from discovering the loss (or from when the loss should reasonably have come to their attention) to make a claim. By making a claim they assign to the CLC all rights of action against the person liable for the loss.
- 8.43. Any payments are made at the CLC's absolute discretion. The CLC is also able to suspend the normal process and move very quickly under certain circumstances, for example to make sure a consumer can complete a house purchase on time.

Chartered legal executives

- 8.44. ILEX Professional Standards (IPS) have submitted an application to the LSB to become an Approved Regulator for awarding probate practice and reserved instrument rights, as well as rule change applications for litigation and immigration. As part of their application IPS have set out the financial protection arrangements they intend to put in place if the application is approved.
- 8.45. The protections will include professional indemnity insurance provided by open market insurers who sign up to minimum terms and conditions. A Qualifying Insurers Agreement is currently being drafted. There will be a maximum limit of £2 million per claim and practitioners will have to buy six years worth of run-off cover.
- 8.46. IPS also intend to set up a compensation fund, similar to those currently run by the SRA and the CLC. Applicants to the fund will have to prove hardship before a claim is paid out.
- 8.47. IPS are also investigating the possibility of setting up an escrow account for use by IPS regulated entities. This could have a number of advantages, including the fact that all annual auditing would be outsourced to the escrow company, a major benefit for sole practitioners.
- 8.48. Currently almost all legal executives are employed in solicitors' firms, and as such are covered by the SRA's rules. In addition to this we are aware that some legal executives that carry out immigration work have obtained their own professional indemnity insurance on the open market.

Notaries

- 8.49. Notaries are qualified lawyers, regulated by the Court of Faculties. Within England and Wales a notary is authorised to carry out reserved legal activities as defined in the Legal Services Act 2007: namely, notarial activities, reserved instrument activities, probate activities and the administration of oaths, subject to the Notarial Rules governing the

⁸⁰ See CLC Fees Framework 2012 (http://www.clc-uk.org/pdf_files/regulatory_arrangements/other/CLC_Fees_Framework_2012.pdf)

profession. However, notaries primarily deal with authentication and certification of signatures and documents for use abroad and general legal practice. Notaries who are also solicitors carry out most of their domestic work (including litigation) in their capacity as solicitors and are subject to regulation by the SRA.

- 8.50. The rules which affect Notaries are similar to the rules which affect Solicitors. They must be fully insured and maintain fidelity cover for the protection of their clients and the public. They must keep client money separately from their own and comply with the Notaries Practising Certificates Rules, the Notaries Accounts Rules 1989 (as amended), and the Notaries Practice Rules 2009 (as amended).
- 8.51. In accordance with these rules, notaries must provide their regulator, the Faculty Office, with evidence of insurance against civil liability for professional negligence incurred by them in connection with their practice as a notary. In addition, a notary must provide the Faculty Office with evidence of insurance against financial loss suffered by a third party in consequence of any dishonest or fraudulent act or any omission by the applicant in connection with their practice as a notary. This information has to be submitted before a practising certificate can be issued or renewed.
- 8.52. The current minimum limit for professional indemnity insurance is £1,000,000. At the moment there is no prescribed figure for fidelity insurance cover. However, there are new Notaries Practising Certificate Rules which are due to come into effect in October 2013. These will introduce a minimum limit which will be fixed from time to time by Order of the Master of the Faculties. When first introduced, the minimum limit of fidelity insurance is likely to be not less than £1,000,000.
- 8.53. Because all notaries have to hold both professional indemnity insurance and fidelity insurance, notaries are not required to have a compensation fund. Notaries may practice in conjunction with their solicitor's practice but must maintain a degree of professional independence. However, it is possible that notarial practice by a solicitor in conjunction with their solicitor's practice may be covered by the SRA compensation fund should a claim arise.

Accountants

- 8.54. The Institute of Chartered Accountants in England and Wales (ICAEW) has applied to the Legal Services Board to become an approved regulator and licensing authority for probate activities. As part of their application ICAEW set out the financial protection arrangements they would put in place for those in their regulated community conducting probate activities if the application were to be approved.
- 8.55. These arrangements would include rules on holding client money and a requirement to hold professional indemnity insurance. Insurance is provided by 'participating insurers' who agree to provide terms which meet ICAEW's approved minimum wording. For probate practitioners there is a minimum limit of £500,000 per claim. Run-off cover should be maintained for at least two years.
- 8.56. There is also a probate compensation scheme which is funded by a levy on firms. The scheme may make grants on a discretionary basis. Only bodies corporate or registered charities with an annual turnover of less than £1 million in the previous accounting year are eligible to apply for a grant. An applicant would have to show that they had suffered loss due to fraud or dishonesty, or failure to account for money. Applications should be made

within 12 months of the time when the loss came (or should reasonably have come) to the knowledge of the applicant.⁸¹

Legal Ombudsman

- 8.57. The Legal Ombudsman can award compensation to consumers up to a maximum of £50,000, although this level of compensation is only likely to be awarded where a consumer is able to show a direct financial loss due to the lawyer's actions.⁸² The SRA minimum terms and conditions provide that where an award is made by the Ombudsman which is not met by the firm, it must be covered by the relevant qualifying insurer. Some stakeholders raised concerns that the Legal Ombudsman may also make awards in relation to poor service, and insurers now have to cover these claims in some cases, although service quality is not something they have had to cover in the past. There is some resistance to this – for example, one respondent to the Legal Ombudsman's consultation on changes to the Scheme Rules (an insurer) said they "already contest any order of compensation above the value of £20,000".⁸³
- 8.58. The Legal Ombudsman have told us that cases are typically referred to indemnity insurers in cases where the firm is unable to meet the payment (for example because they have closed down or gone into administration). It is also possible that where the Ombudsman makes an award and this is not met either by the firm or by professional indemnity insurance, the award could then fall on a regulators' compensation fund. Between May 2012 and January 2013 approximately 120 cases were referred to indemnity insurers or regulators' compensation funds by the Legal Ombudsman.

⁸¹ See http://www.legalservicesboard.org.uk/Projects/pdf/20121214_icaew's_probate_application_anx_9-23.pdf, annex 18.

⁸² Legal Ombudsman, A Guide to our Revised Scheme Rules, p. 3.

⁸³ http://www.legalombudsman.org.uk/downloads/documents/consultations/Scheme_rules_consultation_report_121119_FINAL.pdf, p. 22.

The Legal Services Consumer Panel was established under the Legal Services Act 2007 to provide independent advice to the Legal Services Board about the interests of consumers of legal services in England and Wales. We investigate issues that affect consumers and use this information to influence decisions about the regulation of legal services.

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