

Compensation Fund eligibility criteria

Summary of consultation responses

Regulatory Policy Unit

1 August 2014

Introduction

- 1 This report follows the SRA's recent consultation on the proposal that the Compensation Fund should be limited to certain types of consumers.
- 2 We proposed that the SRA Compensation Fund Rules 2011 are amended to limit eligibility to claim on the Compensation Fund to:
 - individuals;
 - micro-enterprises (businesses with a turnover not exceeding £2 million);
 - charities with an annual income of less than £2 million; and
 - trustees of a trust with a net asset value of less than £2 million.

Overview and next steps

- 3 The consultation was launched on 7 May 2014 and closed on 18 June 2014. It was supported by the publication of a series of questions and answers and key documents following our [initial research](#) into the SRA's compensation arrangements. We would like to thank everyone who responded to the consultation.
- 4 A total of 45 responses were received from stakeholders, including individual solicitors and firms of varying sizes, the Council of Mortgage Lenders, the Legal Services Consumer Panel, the Conveyancing Association, the Law Society of England and Wales and local law societies. A list of respondents is attached at the end of the paper.
- 5 We received a range of views through the consultation exercise. Those that supported the implementation of the criteria agreed that the Compensation Fund had been established for the specific purpose of protecting more vulnerable consumers and not large corporate consumers, which are better placed to ensure their interests are protected. The Law Society agreed with the logic of the proposals but considered that further assessment of the potential impacts needed to be considered.

- 6 For those respondents who disagreed with the proposals, their central concern was that without the guarantee provided by the Compensation Fund, lenders and other corporate clients would be less likely to instruct small firms.
- 7 Some respondents commented on the need to ensure that our approach was clearly set out and information was made available to consumers. This included the need to carefully define specific terms and consider further the impact on charities who were named beneficiaries in probate matters yet had not instructed the firm as executors of a will.
- 8 A number of responses raised concerns about the length of the consultation period and the lack of impact assessment.
- 9 We have carefully considered all of the responses we received and concluded that the eligibility criteria should be implemented for the reasons set out below.

The responses

Question 1 - Do you agree with the proposal to introduce eligibility criteria for applicants making a claim on the SRA's Compensation Fund?

- 10 A significant number of responses (over a quarter) fully agreed with the proposal. Some felt that larger consumers could make choices about which firms they instructed and on what terms; though other respondents felt that this was exactly the problem and lenders would be able to exclude small firms if they presented a greater risk. It was considered that consumers would continue to instruct those firms that had the best reputation for the work they wished to have completed and that this would apply to all firms regardless of characteristics such as size of firm or number of qualified staff.
- 11 There was a call by one respondent for the Compensation Fund to "...revert back to its original purpose of being a hardship fund of the last resort...". The Junior Lawyers Division argued in rejecting the proposal that "...*The Compensation Fund was created to maintain the reputation of the legal profession by ensuring that no client would be out of pocket as a result of the actions or dishonesty of a solicitor of their employee...*".
- 12 The Legal Services Consumer Panel in its response endorsed the case for the eligibility criteria. The Panel recognised that large corporate consumers were better able to assess the risks and suffer less from information asymmetries which existed for individual and other small entities in the legal services market. The Law Society said that "...*We recognise the logic of the position that, if the SRA does not currently make such awards but expends significant sums of money establishing the facts, it might be more appropriate to be explicit about the usual position. However this paper comes at a time when the SRA is also proposing significant*

other changes to the protection available to lenders through the PII minimum terms and conditions...".

- 13 Those that rejected the proposal did so primarily on the grounds that any eligibility criteria would dissuade clients from instructing firms in conveyancing and probate matters and the impact would be harder felt by smaller firms. It was considered that the Compensation Fund acted as a guarantee for clients and therefore, there was no reason for clients to be persuaded to release monies to a firm/practitioner. The Council of Mortgage Lenders commented that "...*The consequences may include financial institutions will need to consider how best to protect themselves...lenders may be driven to reconsider who they work with...lenders may also consider using conveyancers from other parts of the legal market...*".
- 14 Having considered the consultation responses, it remains our view that the eligibility criteria should be implemented. There are clear advantages to clients and consumers in being able to claim on a Compensation Fund for financial loss arising from misuse or misappropriation of client money. However, entities regulated by the SRA serve a wide range of clients. Some consumers clearly have the resource to be able to protect themselves than others, for example by insuring themselves against such losses, or demanding that solicitors take additional steps to protect client money, for example by holding it in an escrow account. Given the differential capacities of consumers to protect themselves, the SRA considers it appropriate to limit who can make a claim to the Compensation Fund.

The Compensation Fund does not provide '*compensation*' in the sense of the wrongdoer providing redress for its own fault. When the SRA makes an award from the Compensation Fund it makes a grant from a Fund that all regulated individuals/firms contribute to. The individual or firm at fault does not fund the costs of compensation directly. In most cases the costs of claims flowing from an individual solicitor's dishonesty will far outstrip the total contributions he has made to the Fund over his/her professional lifetime: the gap is, of course, paid by the many firms and individuals that contribute without ever giving rise to a claim. Although the Compensation Fund has the option of seeking redress against the individual at fault in a personal capacity, such action is often impractical due to the costs of legal action and the poor chances of recovery.

Question 2 - Do you agree that only individuals, small enterprises, charities and trusts should be able to claim from the SRA's Compensation Fund?

- 15 Those respondents that agreed with the proposal of introducing the eligibility criteria agreed with the criteria itself and saw that it was akin to criteria which had been developed and implemented by the Legal Ombudsman and the Financial Conduct Authority. Some respondents commented that the criteria was potentially too narrow and would require interpretation and frequent adjustment and it was therefore, appropriate for certain terms to be defined or reconsidered. The Sole Practitioners Group commented across all questions that "...[our view] *is that the resources in the fund should be husbanded much more closely, to a certain extent in line with the proposals, but on the basis of flexibility rather than creating a rigid determination between claims, which may give rise to legal disputes which would end up being fought by the Fund using solicitors contributions for that purpose...*".

- 16 There was some concern about the impact on BAME firms. GB Asian Lawyers said "*...We believe that any attempt to exclude large financial institutions...is likely to result in a restriction of their conveyancing panels, resulting in the exclusion of small firms...This will disproportionately affect BAME owned firms...*". There was however, little by way of evidence or analysis offered by this respondent to support the opinion.
- 17 On respondent said that "*...We do not agree to limit the class of entity that can claim on the Compensation Fund thus avoiding claims by lenders. In reality they don't claim because they have to show hardship but if they are prohibited from making a claim it will again end up with lenders excluding high street firms from panels...*". This was a view shared by several who were concerned about the impact on firms which are members of lenders' panels.

SRA response

- 18 We have carefully analysed and considered the responses. Our view is that we should continue with the proposal to implement criteria that restricts eligibility. We do not consider that this will lead directly to changes in lenders panels but are conscious of that risk. Our view is that lenders are already aware that they will be unlikely to be awarded a payment from the Compensation Fund (though the possibility does remain given the absence of any specific exclusion and the Fund's discretionary nature). These criteria will provide certainty and clarity for some larger consumers, help ensure that incentives to make positive choices about risk are aligned with consumer interests and good regulatory outcomes and help reduce the cost of administering the Fund.
- 19 Ahead of preparing rules to deliver this change we will refine the criteria to the extent necessary to ensure that the policy objective is delivered clearly.

Question 3 - If you do not agree with the proposal, please offer any alternative suggestions for reducing the burden on the SRA's Compensation Fund.

- 20 Very few direct alternative suggestions were made but there were suggestions (such as from the Sole Practitioners Group above) which could be the basis of an alternative approach. One other respondent suggested a more tiered approach that segmented the market.

SRA response

- 21 Our view is that the proposed criteria are the most effective way to deliver a Compensation Fund that is focused on consumers that need help to operate in the legal market. Alternatives would be difficult to apply if they involved greater flexibility and may lead to legal challenges and higher administrative costs. There may be further options for reform in the future and the ideas and views gathered through this consultation will feed into that analysis.

Question 4 - Do you have any views about our assessment of the impact of these changes; and, are there any impacts, available data or evidence that we should consider in finalising our impact assessment?

- 22 Very few respondents answered this question in any detail and several referred to a lack of time to enable them to do so. The Birmingham Law Society emphasised this point, noting that, although the "*...changes appear attractive...the risk is of unforeseen consequences resulting in adverse publicity and a loss of faith by the public...*". The Tunbridge Wells Law Society's Regulatory Committee said "*...a root and branch review of the schemes for complaint and compensation applicable to legal services providers is required...*". The Law Society said that the SRA's stakeholders have the expectation that the SRA will remedy matters if they go wrong and identified "*....a newly created gap in relation to what will happen to a consumers' claims where a practitioner's insurance is no longer adequate and the practitioner does not have the personal resources to meet them...*".
- 23 Several respondents referred to potential impacts of the proposals within the body of their responses. The Council of Mortgage Lenders suggested the possibility of "*...a very significant reduction in small firms and sole practitioners obtaining work from lenders who previously allowed them on their panels...*". The Law Society suggested that if this were to happen "*...an assessment should be made about the impact on BAME practitioners...*".

SRA response

- 24 Regulatory obligations in respect of the of client money are present regardless of the size and makeup of a firm or its other characteristics. It is these arrangements which safeguard client money and are the primary driver of consumer confidence. As part of a firm's risk management, they should focus on how the misuse or misappropriate can be prevented through developing effective and robust control environments for the holding of client money.
- 25 Given that most claims by large clients are not met, it is difficult to envisage that the proposals will have material impact on the composition of lenders' conveyancing panels.

Summary of our response and next steps

- 26 The SRA's position remains that the protection afforded through the SRA's Compensation Fund should be focussed towards those consumers that are not in a position to secure favourable terms of engagement and are less likely able to assess risks. We will continue to develop our proposal before proceeding with implementation of the eligibility criteria together with the publication of any guidance for consumers.

Consultation Respondents

We received 45 submitted by, or on behalf, of a range of organisations as follows:

Breakdown of Respondents

The Law Society 1
Firms and individuals in private practice 19
Representative groups 5
Local law societies 18
Lenders/Lender Associations 2

Respondents to the Consultation

This list includes only those who have agreed to their names appearing in a list of respondents:

Stanley Jacobs solicitors
Julian Cohen solicitors
Wilson & Bird solicitors
McManus Seddon Runhams
Ian Newbury & Co
Surrey Law Society
Access Law LLP
Clifton Imgram LLP
Mayfield Bell
Devon & Somerset Law Society
Southend on sea & District Law Society
O'Neill Patient solicitors
Northampton Law Society
Asian Lawyers GB
Alexander & Co LLP
Chester & North Wales Law Society
Leicester Law Society
Plymouth Law Society
Gill Akaster LLP
Legal Services Consumer Panel
Birmingham Law Society
Maurice Gyer

Middlesex Law Society
Building Societies Association
Hertfordshire Law Society
Junior Lawyers Division
Newcastle Upon Tyne Law Society
Sole Practitioners Group
The Law Society of England & Wales
Scott Wright Solicitors
Conveyancing Association
Council of Mortgage Lenders
Cambridgeshire & District Law Society
Manchester Law Society
City of London Law Society
Sue Petritz
Leeds Law Society
Tunbridge Wells, Tonbridge & District Law Society
Sunderland Law Society