Solicitors Regulation Authority

SRA response

Review of the Regulation of Corporate Legal Work

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Introduction

1. We welcome the contribution that the report of Nick Smedley's Review of the Regulation of Corporate Legal Work makes to the consideration of the way forward for one important area of legal regulation.

2. This review needs to be understood in the context of other developments taking place in the regulation and delivery of legal services. The Legal Services Act (LSA) was passed in 2007. It represented a key stage in a process which began in 2001, with the publication of the Office of Fair Trading's report "Competition in the Professions", which recommended the removal of unjustified restrictions on competition within the legal professions.

3. The Government subsequently commissioned Sir David Clementi to undertake an independent review of the regulatory framework for legal services in England and Wales. Clementi reported at the end of 2004. He concluded that the system had insufficient regard for the interests of consumers, and made wide-ranging recommendations relating to the delivery and regulation of legal services. These included the development of alternative business structures (ABSs) for legal services firms, involving the removal of restrictions on the structure, ownership and management of firms. Clementi's recommendations formed the basis of the LSA.

4. Anticipating one of the main planks of both the Clementi Report and the LSA, the Law Society began in 2004/5 to separate its regulatory functions from its representative functions. In 2006 it established the Solicitors Regulation Authority (SRA) as an independent, public interest regulator within the Law Society Group. The SRA published its strategy [https://www.sra.org.uk/sra/corporate-strategy/] late in 2006. From the outset, we were clear that the implementation of new forms of regulation, based on the firm rather than the individual solicitor, would be required in order to deliver the objectives of the LSA.

5. A key provision of the LSA was the establishment of the Legal Services Board [http://www.legalservicesboard.org.uk/] (LSB) as the oversight regulator for the approved regulators of the legal professions in England and Wales. The LSB was formed in 2008. In April 2009, following public consultation, it published its first business plan, including the aim of widening access to the legal market through the development of a licensing regime for ABSs. The LSB described ABSs as one of the most important areas of its work and indeed of the new regulatory framework, and noted that the SRA had already made significant rule changes to allow it to regulate legal disciplinary practices (LDPs), the first stage in the implementation of new forms of business structure.

6. The SRA introduced LDPs on 31 March 2009, at the same time modernising our powers to allow us to regulate firms as well as individuals. Our work on the development and implementation of LDPs serves as a stepping stone to the much greater change in the legal services market which will be delivered through the licensing of ABSs.

7. In May 2009, the LSB published a discussion paper, 'Wider Access, Better Value, Strong Protection', about the development of the regulatory regime for ABSs, with a closing date for responses in August. In it, the LSB sets out its objective for a mid-2011 start date for ABS licensing.

8. The SRA published its own discussion paper on new forms of practice and regulation, Regulating alternative business structures, intended to be complementary to the LSB's paper, in June 2009. In the paper, we make clear that the implementation of ABSs should be seen in the context of the introduction of more-flexible powers and must indicate a broader shift in the focus of the SRA's regulation, which has application across all forms of legal practice:

   "We want to concentrate our resources on dealing with serious risk. We want to encourage law firms to tackle risk themselves wherever possible, reducing the overall regulatory burden and allowing us to concentrate upon those who can't, or won't, put things right. To do that, we need to build a new relationship between the SRA, as regulator, and the firms we regulate."

9. The SRA believes that consumers must be confident that all organisations which it regulates are subject to the same ethical standards, standards of service and consumer

protections as each other. This applies whether those organisations are new types of business structure or more-traditional law firms, and regardless of their size or the kind of work which they undertake. However, whilst the professional standards must be common, the level of risk posed will be variable.

10. Firms which are able to demonstrate that they have strong consumer safeguards and sophisticated systems for managing risk in place can properly be given greater freedom in the way they meet the SRA's regulatory requirements. This clearly signals the development of a new model of firm-based regulation under which, where appropriate, firms manage risk themselves under the supervision of the SRA.

11. The SRA will still need, where necessary, to undertake its investigative and disciplinary role, in relation to both firms and individual solicitors. It will also continue to deal with the quality assurance of individual solicitors, supporting the development and maintenance of professional competence through the quality standards framework. However, the SRA will develop a supervisory relationship with firms regulated under the new model, building on our existing monitoring and advice functions.

12. The delivery of ABS licensing in 2011, and the wider work on firm-based regulation, will be delivered through a major project, sitting alongside, but separate from, the SRA's existing Enabling Programme (established to reform our processes and introduce the modern information technology essential for new forms of regulation). The project will encompass a number of workstreams, including one for ABSs. It will be overseen by a group reporting to the SRA Board. The group may include external members, and will be informed by an external consultative group.

13. We are currently establishing the project. It will need to be appropriately led and resourced. The skills required to undertake direction of the project—which will be at a senior level—and many of the specialist skills necessary to support it, will be acquired externally. The specific implications of the project in relation to the corporate legal sector are set out in paragraphs 41–42 [#part-41] below.

Hunt, Smedley and ABSs

14. The position on reviews of regulation is confused. In 2008, whilst the LSB was being formed, the Law Society set up two reviews of its own. One, a Legal Regulation Review

under Lord Hunt, published its Initial Response to Evidence (PDF 22 pages, 135K) in May 2009. Lord Hunt expects to publish his final report in summer 2009. The other, Nick Smedley's Review of the Regulation of Corporate Legal Work, published its report (PDF 125 pages, 789K) in late March 2009.

15. In a recent consultation on the rules it will be making to underpin the separation of regulatory from representative functions within approved regulators, Regulatory Independence, the LSB says:

    "First, we consider that an approved regulator should, in relation to those delegated functions and acting together with its regulatory arm [our italics], be able to commission independent and occasional strategic reviews of its structural framework. These reviews should assess the extent to which mechanisms in place remain fit for purpose."

16. This seems to us to represent obvious good practice. It is unfortunate that the SRA was not consulted by the Law Society about the setting up of either the Hunt or Smedley reviews, and indeed received only minimal notice of their establishment (though it is not, of course, the fault of either Lord Hunt or Nick Smedley that good practice was not followed). The challenge for the SRA now is to interpret the outputs of the two reviews against the wider background of the reform and modernisation of the legal services market in the interests of consumers required by the LSA, to which the SRA is already committed.

17. This has not been made altogether straightforward by the fact that, although we understand that Nick Smedley's review is intended to be a sub-strand of Lord Hunt's, the relationship between the reviews appears complex. Thus, at the end of March Nick Smedley presented 34 recommendations (some relating to the detail of the SRA's organisation and structure), including a recommendation that the SRA should respond publicly to each within two months:

    "If the SRA decides not to implement this report (or at least the substance of its recommendations)…I recommend that the Law Society, in consultation with the LSB and leading corporate firms, considers whether or not it should establish a new regulatory body, separate from the SRA, to undertake some or all of the

regulatory functions in respect of corporate firms set out in the report."

18. In May, Lord Hunt urged caution in relation to the Smedley recommendations:

"I read the report by Nick Smedley into the regulation of corporate work with great interest and continue to digest its various arguments, conclusions and recommendations. It may well be that the Smedley conclusions set out a useful direction of travel but I do not believe they should be acted upon hurriedly or in isolation and I should like to take the opportunity to dovetail his useful work into my wider review. At this stage, I am reserving my position with regard to his notion of establishing a separate regulatory structure for a particular type of firm, either within or out with the structure of the SRA."

19. In the same month, in Wider Access, Better Value, Strong Protection (which remains open for consultation until 14 August) the LSB drew attention to the commonalities between what is required to regulate large corporate law firms effectively and what will be required to regulate ABSs under the provisions of the LSA:

"We do not comment here on the specific recommendations in the Smedley report. However, we suggest there are some common themes and synergies between possible changes to the future regulation of corporate legal work and the future regulation of ABS firms. In developing their licensing rules, including the ongoing approach to supervising ABS firms, regulators will need to take a view about the risks associated with these firms and the appropriate tools and organisational structures for regulating larger business.

This may have a significant impact upon the operational model of the regulator and its staffing."

20. We understand both Hunt and Smedley to be indicating their broad agreement with the SRA's developing approach to regulation which we have referred to in paragraphs 8–11 [#part-8] above. For example, Lord Hunt refers to mandatory self-regulation by firms and to the robustness of firms' internal governance arrangements. Nick Smedley suggests that his proposals on regulation of the corporate sector

would help prepare the SRA and the profession for the new environment of ABSs.

21. There are clearly particular regulatory issues and gaps in relation to the regulation of the corporate legal sector which the SRA needs to deal with quickly to build confidence and trust with corporate firms and clients. However, we believe that there is a strong advantage in integrating the overall approach to better regulation of the corporate sector within the wider development of a graduated regulatory regime based on the sophistication of a law firm's internal systems and structures. This integrated approach will, of course, take account of the fact that the information asymmetry which often exists between lawyer and private client (and which regulation is partly designed to redress) is largely absent, or at least very much reduced, in the large corporate sector.

22. We therefore agree with Lord Hunt's conclusion that it does not make sense to consider the Smedley recommendations in isolation from the wider concerns. However, we do not consider that further progress should be left to await the outcome of Lord Hunt's review, the timetable for which sits uneasily against the already well-established reform timetables of both the SRA and LSB.

23. Against the background summarised above, it is not possible for the SRA to give the all-or-nothing response to its recommendations which the Smedley Report requests. Nevertheless, we believe that what we say below will demonstrate our firm commitment to building effective regulation for the corporate legal sector.

The concerns of the City firms

24. Over many years—long predating the establishment of the SRA—the regulation of City firms and the corporate legal sector has occupied a relatively small part of the time and resource of those responsible for regulating solicitors. The reasons for this are not hard to understand. Much regulatory work was driven by complaints, and large corporate firms attract relatively few complaints. Corporate clients have substantial purchasing power and often have their own in-house legal teams. If they are dissatisfied with the service they receive, they are more likely to take their business elsewhere, or to seek redress through the courts, than to complain to the regulator. Nor do large firms represent the same risk of sudden default as small firms or sole practitioners.

25. For these reasons, the SRA and its predecessors have articulated risk as arising mainly from complaints and the possibility of default, particularly when that might impact on the Compensation Fund. This has affected the composition of the SRA's staff, relatively few of whom come from backgrounds in the corporate legal sector.

26. These factors in turn have tended to mean that communication and the exchange of ideas and information between the regulator and the corporate legal sector have been underdeveloped. "Underdeveloped" does not mean "non-existent": for example, our staff have spent a great deal of time engaged in discussions with the corporate sector on international arrangements. Nevertheless, it is significant that we were unaware of the concern about the interpretation of rule 2 [https://www.sra.org.uk/rule2] identified in the Smedley Report, which had never been presented to us in the form set out, and are preparing clearer guidance.

27. It is clear to the SRA, both from the Smedley Report itself and from our own recent contact with representatives of the City firms, that determined and radical action is required to deal with this regulatory inheritance.

28. Some of the key proposals that have been put to us are ones which we believe to be right. Corporate lawyers ought to be able to contact the SRA for high-quality advice on the application of the rules of conduct within the complex environment in which they operate. That means that the SRA needs—quickly—to take steps to ensure that it has a sufficient number of staff with the appropriate skills, knowledge and experience to meet that legitimate need.

29. While the core principles of professional conduct should and must remain common across all sectors of the solicitors' profession, rules need to be sufficiently flexible to accommodate any requirements peculiar to the corporate legal environment. The purpose of that flexibility is not, of course, to benefit corporate lawyers but rather to ensure that their clients can be properly served. It is a matter of public interest for the SRA to ensure that the mechanisms through which the corporate legal sector contributes to the rule-making process work effectively, and that we have the capacity to understand and analyse the arguments and evidence which we receive.

30. All this will require much more active management of the relationship between the SRA and corporate law firms than has been the case in the past, supported by closer involvement of the SRA Board [https://www.sra.org.uk/board] itself.

That work will need to be led at a senior, appropriately-qualified level within the SRA.

31. Underlying all of this is the public interest requirement that corporate law firms in England and Wales should continue to make a major contribution to the UK economy, enjoying a global reputation for the excellence of the service which they provide. Confidence in the relevance and quality of the regulatory regime will play an important part in maintaining that reputation.

32. For all these reasons, we agree with Nick Smedley's recommendation that the SRA must be

    1. a regulator with significantly increased expertise in dealing with the corporate sector,
    2. a regulator which is able to meet the corporate law firms on equal terms,
    3. a regulator which carries out a programme of intensive engagement with the corporate law firms and their corporate clients,
    4. a regulator which is flexible, responsive and nimble in keeping the rules under review, to ensure continuing competitiveness for the UK corporate legal sector,
    5. a regulator with an approach to the rules, and the monitoring and enforcement regime which is proportionate in impact and operation, taking account of the difference in relationship between on the one hand a lawyer and a private client, and on the other a large corporate law firm and its corporate clients,
    6. a regulator with a forward looking, modern and innovative approach to regulation,
    7. a regulator which acts as a source of expert advice and assistance to firms seeking clarity or guidance in unusual, difficult and sensitive matters,
    8. a regulator which is a repository of best practice in the ethical conduct of business, risk management, corporate governance and business systems,
    9. a regulator which can establish benchmarks for such matters, promulgate them and keep them under review.

The way forward

33. We believe, therefore, that there is a high level of agreement between Nick Smedley, the large corporate law firms and

the SRA on both the starting point and the ultimate destination. Where there may be less—although still significant—agreement between the SRA and the Smedley Report is on some of the steps which are required in the immediate future to take us along the route to that destination.

34. Nick Smedley suggests that we continue to underestimate the scale of the changes we now need to make in relation to the corporate sector. In fact, we are acutely aware of the challenges ahead: to develop the SRA's capability to regulate across all sectors and in relation to new forms of legal business will require additional skills and different processes, technology and structures.

35. The work which we ourselves initiated with the City firms over a year ago (which included an information-gathering pilot) has demonstrated our need to acquire new skill-sets in order to regulate the sector more effectively. It is also clear that, for the SRA to be in a position to license ABSs by mid-2011, whilst in our view achievable, will require the delivery of a major programme of work.

36. The SRA must move rapidly to build stronger relationships with corporate law firms, bring in appropriate skills, and improve its ability to identify and deal with issues of particular relevance to corporate firms and their clients. However, the focus of regulation on strategic, system level issues such as audit, risk management and governance appropriate for large corporate firms will in reality be equally applicable to other firms with sophisticated management and risk systems and to ABS regulation. It would be a missed opportunity, and an unnecessary expense, to attempt to put in place regulatory structures for corporate law firms as a separate exercise from the wider development of firm-based regulation.

37. Behind some of the Smedley Report's specific recommendations in relation to the regulation of the corporate sector lies the absence of a sufficiently clear distinction between sophisticated clients and the sophistication of a law firm's own systems and structures. Most of the clients of large firms undertaking mainly or wholly corporate work will be "sophisticated", as will many of those purchasing such services from firms with "mixed" practices. The large firms undertaking corporate work are likely to have sophisticated systems for compliance, risk management and client care in place, as indeed will large

and many smaller firms which do not undertake corporate work.

38. The principles binding solicitors are valid across the spectrum of legal work and firms. The rules must be sufficiently flexible to reflect the needs and interests of sophisticated clients, as well as of other clients. The regulatory supervision and monitoring regime should, however, be based on the sophistication of the firm's structures. That understanding of the issue is central to our thinking on new approaches to regulation, but is difficult to reconcile with the organisational structures and responsibilities which the Smedley Report proposes.

39. We would summarise the position as follows:

    a. The development of an organisational capability in firm-based regulation, focusing on the quality of firms' own management of risk, requires the acquisition of skills, systems and processes which are applicable both to the regulation of sophisticated corporate firms and to the regulation of ABSs.

    b. In addition, the SRA needs to undertake further development of its skills base to ensure that its staff have the appropriate knowledge and experience to discharge its responsibility to regulate the corporate sector properly, taking account of the legitimate needs and expectations of corporate law firms and their clients.

    c. We must also work closely with the corporate legal sector to build confidence in the fitness for purpose of the regulatory regime.

40. The fact that a) does not focus exclusively on the corporate sector does not, of course, mean that large corporate firms will not form a significant part of the process for developing a new model of firm-based regulation. We are quite clear that the piloting of new approaches to regulation must include the adaptation of existing best practice much (but not all) of which is to be found in larger corporate firms. However, b) and c) require immediate action, taken forward in partnership with the corporate sector, building where possible on existing regulatory strengths, and introducing new skills and practices where necessary.

41. We propose to establish, within the framework of our wider firm-based regulation project, a corporate workstream to introduce major improvements into regulating the large corporate legal sector. The workstream's scope and

deliverables will be settled by the SRA Board, and will include

a. the creation of much more effective relationships at senior level between the SRA and large corporate law firms,

b. the establishment of formal mechanisms for engaging with the corporate sector, including the establishment of an appropriately supported Client and Practitioner Panel,

c. the continued upskilling of the SRA, to ensure that we have sufficient staff, in the right places, with the appropriate experience and skill-sets to cover the whole range of regulatory activity as it relates to the corporate sector, including rule-making, monitoring and supervision, advice, investigation, decision-making and prosecution (As part of this exercise we will explore the possibility of secondments into the SRA of corporate lawyers, and the recruitment of staff with relevant skills and experience from outside the legal profession.),

d. the provision of accessible professional ethical advice of the required standard to corporate lawyers, including the feasibility of providing—as some regulators do, in controlled circumstances—"safe harbour" advice (although our initial view is that significant legal and financial issues arise in relation to "safe harbour" arrangements for the corporate legal sector which would limit their value and mean that this may not be a practical solution),

e. changes to organisational structures and roles where identified as necessary, including the possible establishment of a unit concentrating, at least initially, on the supervisory regulation of larger corporate firms and the introduction of an account manager role,

f. the identification and implementation of focused and proportionate methods, including the assessment of risk, for the regulation of corporate firms, feeding into the wider project.

42. The corporate workstream will ensure that, by the end of the project, these individual outputs will have been permanently embedded within the appropriate parts of the SRA's processes and structures. The workstream will be led by a person with the necessary background, skills and seniority, whose advice and ability to command the respect of and build effective working relationships with the corporate sector will play a key part in the project's success.

Conclusion

43. We conclude by discussing a number of the issues raised in the Smedley Report's recommendations.

44. The SRA has already begun to consider future structural requirements, with the assistance of an external consultant. We are quite clear that the changes which will be introduced over the next two years will require significant organisational reform. It is too early at present to embark on wholesale structural change, given that we have yet to see the outcomes of the Hunt Review and the work on development of ABSs being undertaken by both the LSB and the SRA. We may very well wish to call on external advice as the route of travel becomes clearer.

45. It would not be right to embark on Nick Smedley's model of a semi-autonomous division of the SRA, focused entirely on the large corporate sector and with the responsibility for the entire range of regulatory activity, including rules, monitoring, supervision and enforcement. That model runs the significant risk of regulatory capture, and of a perception of unfairness. That does not mean that organisational structures cannot take account of the specific requirements of regulating the corporate sector: the option of creating a dedicated unit to undertake the supervision, monitoring and provision of advice to large corporate firms, perhaps based on the account manager role recommended by Nick Smedley, clearly merits very serious consideration.

46. We do have serious reservations about such a unit being responsible for both supervisory activities and for the fundamentally different regulatory activities of investigation, enforcement and prosecution. The separation of monitoring and advice from investigation, and of investigation from internal sanction or prosecution in the Solicitors Disciplinary Tribunal are core principles underpinning our regulatory operation which must be preserved (minor breaches can, of course, already be dealt with without formal action). We consider that the investigation of regulatory breach in the corporate sector requires staff with appropriate experience, skills and expertise, as do monitoring, provision of advice, drafting of rules, final decision-making and prosecution in relation to that sector.

47. Provided the core principles are preserved, it is right that the rules should be flexible enough to accommodate different categories of legal work. We welcome the opportunity to work with the corporate legal sector in order to identify areas where the current rules do not adequately meet the needs of sophisticated clients (we have recently consulted specifically

on proposals for amendments to the rules relating to conflict of interest and duties of confidentiality and disclosure following issues raised by the City of London Law Society). We believe that the appropriate permanent mechanism for informing this process will be the Client and Practitioner Panel.

48. Proposals for changing the rules particularly affecting the corporate sector should be discussed in the Client and Practitioner Panel, and should be subject to public consultation before being considered by the Rules and Ethics Committee (or any successor which the Board may establish) and then by the Board itself. The Board and its committees would expect to be advised during this process by the SRA's officers, including those with particular expertise in and responsibility for the regulation of the corporate sector. That ensures both that the rule-making process is properly coordinated and integrated across the range of the SRA's work and that issues of particular concern to the corporate sector are identified, analysed and fully considered.

49. We agree that, subject to resources being made available to us, there would be a benefit in the SRA having a London office. We would expect that office to be used by those staff with particular responsibilities in relation to the corporate legal sector and for a range of purposes by other SRA staff operating in the London area—our staff frequently visit London for meetings and events, and we have a large number of field-based staff in London and the South-East. We accept that ease of access and face-to-face contact are important elements in building confidence between the corporate sector and the SRA, but do not believe that the absence of a permanent London office should be treated as an insurmountable obstacle.

50. We are open to the possibility of a future strategic review. However, given the fact that the Hunt Review has yet to report, that there is a clear intent to introduce ABS licensing in 2011 and that our Enabling Programme also has a clear timetable, the decision on any such review, and on its timing, should be a matter for the incoming SRA Board, in consultation with the LSB as oversight regulator, and the representative Law Society in its role as primary consultee on behalf of the profession.