

**EXPLANATORY MEMORANDUM TO
THE LEGAL SERVICES ACT 2007 (MAXIMUM PENALTY FOR APPROVED
REGULATORS) RULES 2009**

2009 No. 3249

1. This explanatory memorandum has been prepared by the Legal Services Board (the “Board”) and is laid before Parliament by Command of Her Majesty.

2. **Purpose of the instrument**
 - 2.1 The purpose of this instrument is to make rules prescribing the maximum amount of financial penalty that may be imposed on an approved regulator in exercise of the Board’s power to impose such penalties under section 37 of the Legal Services Act 2007 (c.29) (“the Act”).

 - 2.2 In summary, this instrument provides for the maximum to be calculated by reference to the income which the regulator derived from its regulatory functions in respect of the most recent financial year for which the regulator has audited accounts. The maximum amount of a financial penalty is set at X per cent. of that income.

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

None.

4. **Legislative Context**
 - 4.1 Part 2 of the Act establishes the Board as a body corporate to act as an independent oversight regulator of legal services. Legal services regulated under the Act are referred to as “reserved legal activities” and it is an offence for any person to carry on any such activity without being authorised to do so by one of the new approved regulators or being exempt. The Board oversees the approved regulators and seeks to ensure that they carry out their regulatory functions to the required standards.

 - 4.2 Section 37 of the Act enables the Board to impose a financial penalty on an approved regulator if the Board is satisfied that the regulator has failed to comply with any requirement imposed on the regulator under certain specified provisions of the Act. These relate to the separation of a regulator’s regulatory and representative functions (section 30 of the Act) and the application of practising fees payable to approved regulators (section 51 of the Act). A financial penalty may also be imposed in respect of non-compliance with directions given by the Board to require the regulator to take remedial steps in certain circumstances (section 32 of the Act).

5. Territorial Extent and Application

This instrument applies to England and Wales.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- *What is being done and why*

7.1 The Act reforms the way in which legal services are regulated in England and Wales. The aims of the Act are to simplify the existing regulatory framework by establishing an oversight regulator, the Board, and to improve consumer confidence and the way in which complaints are dealt with by establishing an independent complaints handling body, the Office for Legal Complaints.

7.2 Part 4 of the Act gives the Board certain enforcement powers. These include the ability, under section 37, to impose a financial penalty on an approved regulator.

7.3 Section 37(4) of the Act provides that the Board must make rules prescribing the maximum amount of a penalty which may be imposed under section 37.

7.4 Rule 2 provides that the maximum amount which the Board may impose on an approved regulator is an amount equal to 5 per cent. of all income which the approved regulator derived from its regulatory functions in respect of its most recent accounting period. "Regulatory functions" is a term specifically defined in section 27 of the Act.

7.5 The Board considered a number of different factors when coming to the formulation proposed in Rule 2. These included consideration of:

- the responses it received to the proposal in its consultation document (see Section 8 below);
- the penalty powers given to the Legal Services Complaints Commissioner (the "LSCC") under the terms of the Legal Services Complaints Commissioner (Maximum Penalty) Order 2004. This order gives the LSCC the power to fine a body the lesser of £1 million and 1 per cent. of a body's total income; and
- the penalty powers given to a number of economic regulators in the utility sector which allow maximum penalties of up to 10 per cent. of turnover.

7.6 The penalty powers given to the LSCC were looked at by the Board because it is an example lifted from the legal sector and involves the imposition of a penalty on a legal sector regulator. However, the Board does not believe that the LSCC provides a compelling reference point for the LSB's powers because the LSCC only regulates one sub-section of the current activities of the Law Society. It is the Board's responsibility to oversee regulation of all the approved regulators and to ensure that sufficient sanctions and deterrents are in place to deter systematic regulatory failure and to ensure its rapid correction if and when it occurs. However, at the same time the Board recognises that the 10 per cent. of turnover figure prevalent in other regulated sectors is also not a suitable figure. This figure is one that is generally applied to economic entities and the Board recognises that this model does not fit well with the scale of activities of the approved regulators.

7.7 The above analysis led the Board to decide on a maximum financial penalty which recognises the potential for significant consumer detriment in not setting a level which posed an appropriate deterrent and the fundamental differences that regulation of the legal services sector as a whole has to other established comparators.

- **Consolidation**

7.8 This instrument makes rules required under the Act. There are no issues relating to consolidation.

8. Consultation outcome

8.1 The Board has carried out a consultation on the maximum financial penalty rules. It published a consultation document on 3 August 2009, which ran for 12 weeks and consulted a range of bodies including the approved regulators .

8.2 14 responses were received to the consultation. These included responses from all of the approved regulators, other than the Association of Law Costs Draftsmen, and from other interested parties. All but one of the respondents raised concerns about the formula that the Board proposed to adopt to set the maximum amount. This formula was that the maximum penalty would be set at the greatest of:

- an amount equal to £250 per individual that the approved regulator regulates;
- an amount equal to £5,000 per entity that the approved regulator regulates; or
- £10 million.

8.3 Using this formula would result in a maximum fine of around £28 million for the Law Society and £10 million for the Bar Council.

- 8.4 Having considered the concerns raised, the Board amended its policy by setting the amount of the maximum financial penalty by reference to the income which the approved regulator derived from its regulatory functions in respect of the most recent financial year for which the approved regulator has audited accounts. The maximum amount of a financial penalty is set at 5 per cent. of that income.
- 8.5 Using this formula would result in a maximum fine of around £5.4 million for the Law Society and £300,000 for the Bar Council.

9. Guidance

None.

10. Impact

- 10.1 An Impact Assessment was prepared and was included in the consultation documents.
- 10.2 A copy of the final Impact Assessment is attached to this memorandum.

11. Regulating small business

The legislation does not apply to small business. However, it may be possible that an approved regulator chooses to pass on the cost of any financial penalty to those it regulates by a way of an increase in the cost of a practising certificate. If this occurred on a regular basis it could have a disproportionate impact on smaller law firm businesses. In mitigation, the Board believes that the use of a financial penalty is likely to be a rare event and that if it is used, the maximum it proposes (which is the maximum and is therefore not indicative of the likely average level of a penalty) when coupled with the Board's overarching duty to act proportionately, is not significant enough to cause such an impact.

12. Monitoring & review

The Board will review the maximum amount of the penalty in light of its developing policies on enforcement and compliance and its experience of using the financial penalty as an enforcement tool.

13. Contact

Lesley Davies at the Legal Services Board (Tel: 020 7271 0071 or Email: lesley.davies@legalservicesboard.org.uk) can answer any queries regarding this instrument.

Summary: Intervention & Options

Agency: Legal Services Board ("LSB")	Title: Impact Assessment of the statutory instrument (to be made under Section 37(4) of the Legal Services Act) prescribing the maximum amount of a financial penalty that can be imposed on an Approved Regulator	
Stage: Decision	Version: Final	Date : December 2009
Related Publications: <ul style="list-style-type: none"> Section 37 of the Legal Services Act 2007 (the "LSA") Consultation Paper – "Compliance and Enforcement – Statement of Policy. Consultation paper on compliance and enforcement strategy (including maximum financial penalty), draft statutory instrument and rules" Responses to Consultation Paper 		

Available to view or download at: <http://www.legalservicesboard.org.uk>

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What is the problem under consideration? Why is government intervention necessary?

The LSA gives the LSB the power to impose financial penalties on Approved Regulators in certain circumstances. Section 37(4) of the LSA requires the LSB to make rules prescribing the maximum amount of a penalty that can be imposed. This Impact Assessment considers what the maximum penalty should be.

A financial penalty can be imposed where an Approved Regulator has failed to comply with any requirement imposed on an Approved Regulator by: (i) the LSB's internal governance rules (the separation of the regulatory and representative functions) made under Section 30 of the LSA; (ii) directions given by the Board under Section 32 of the LSA (for example for a failure to comply with any requirement of the LSA); and (iii) Section 51 of the LSA (requirements in relation to practising fees) or by any rules that the LSB may make under that section. Each of these requirements is designed to ensure that the legal services market operates in a way which gives consumers confidence in the way that legal services are regulated.

What are the policy objectives and the intended effects?

The policy objective is to comply with the requirements of the LSA and make rules prescribing the maximum amount of a penalty that can be imposed. The intended effects are that improved regulatory performance will encourage compliance by Approved Regulators with legislative and policy requirements which will in turn lead to better outcomes so that:

- consumers are more confident in accessing the legal services market and can make better informed decisions about purchases; and
- cultures and systems of quality assurance are embedded throughout the legal services sector to give consumers confidence in the services they purchase.

To meet these objectives, any maximum amount must provide sufficient deterrent value while remaining proportionate.

What policy options have been considered? Please justify any preferred option.

The LSB focussed on two options. The base case of 'do nothing' is not a viable option in this case because the LSA requires the LSB to make rules prescribing the maximum amount of a penalty. However, the options presented are compared to a hypothetical base case of 'do nothing'.

This Impact Assessment examines two options: (1) the preferred option set out in a previous consultation; and (2) the LSB's preferred option. In short this involves setting the maximum penalty as an amount equal to 5 per cent. of all income generated by an Approved Regulator from the exercise of its "regulatory functions" (as defined in Section 27 of the LSA). This option is preferred because it is considered to set a maximum with significant deterrent value but which remains proportionate.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

This is a new power granted to the LSB. We will review the maximum amount of the penalty in the light of our developing policies on enforcement and compliance and our experience of using the financial penalty as an enforcement tool. Any revisions undertaken will be subject to the full consultation requirements of the LSA and best practice.

Ministerial Sign-off For Final Stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister:

Not applicable

..... Date:

Summary: Analysis & Evidence

Policy Option: 1

Description: Set the maximum penalty as the greatest of: (i) an amount equal to £250 per individual that the Approved Regulator regulates; (ii) an amount equal to £5,000 per entity that the Approved Regulator regulates; or (iii) £10 million.

COSTS	ANNUAL COSTS		<p>Description and scale of key monetised costs by 'main affected groups'</p> <p>The maximum penalty under this option could result in a maximum penalty of around £28 million for the Law Society and £10 million for the Bar Council. Fines would also potentially involve significant reputational damage for Approved Regulators.</p> <p>This is a relatively complicated penalty structure which would impose costs on Approved Regulators, who would be required to provide information on the number of entities and individuals they regulate, in addition to their turnover. The LSB would also face costs monitoring and enforcing this penalty structure.</p>
	One-off (Transition)	Yrs	
	£ Negligible		
	Average Annual Cost (excluding one-off)		
	£ Negligible		Total Cost (PV) £ Negligible
<p>Other key non-monetised costs by 'main affected groups'</p> <p>There will be some cost of compliance for Approved Regulators, given the possibility of a fine increases the risk in which they operate. Given this option in effect provides a lower bound (of £10 million) for the maximum fine, such costs could be significant for, and may impact disproportionately on, smaller Approved Regulators. If regulators chose to pass on penalties in the form of increases in the costs of practicing certificates, the regulated bodies would ultimately bear these costs.</p> <p>Any subsequent appeals of fines would generate costs for all parties and HMCS given appeals would be heard at court. Due to the expected low volume of cases, such costs are not expected to be significant.</p>			
BENEFITS	ANNUAL BENEFITS		<p>Description and scale of key monetised benefits by 'main affected groups'</p> <p>There is no financial incentive for the LSB to impose high penalties: fine income will be paid into the consolidated fund.</p>
	One-off	Yrs	
	£ Negligible		
	Average Annual Benefit (excluding one-off)		
	£ Negligible		Total Benefit (PV) £ Negligible
<p>Other key non-monetised benefits by 'main affected groups'</p> <p>The maximum financial penalty proposed will provide a significant incentive for improved regulatory performance by the Approved Regulators which in turn will give consumers confidence in the services provided. Given the deterrence effect provided, the efficiency of the regulatory system should be improved.</p>			

Key Assumptions/Sensitivities/Risks

Assumptions are:

- the proposed maximum financial penalty will act as a deterrent;
- the circumstances in which the maximum will be used will be exceptional; and
- the level of any financial penalty imposed will always be proportionate to any breach

Price Base Year N/A	Time Period Years N/A	Net Benefit Range (NPV)	NET BENEFIT (NPV Best estimate) £ Negligible
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What is the geographic coverage of the policy/option?	England & Wales			
On what date will the policy be implemented?	January 2010			
Which organisation(s) will enforce the policy?	The LSB			
What is the total annual cost of enforcement for these organisations?	£ NIL			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	Yes.			
What is the value of the proposed offsetting measure per year?	£ NIL			
What is the value of changes in greenhouse gas emissions?	£ NIL			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	N/A	N/A	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)	
Increase	£ Negligible	Decrease	£ Negligible	Net £ Negligible

Key:

Annual costs and benefits: Constant Prices

(Net) Present Value

Summary: Analysis & Evidence

Policy Option: 2

Description: The setting of the maximum amount of penalty as an amount equal to 5 per cent. of all income generated by an Approved Regulator from the exercise of its “regulatory functions” (as defined in Section 27 of the Act)

COSTS	ANNUAL COSTS		Description and scale of key monetised costs by ‘main affected groups’ Approved Regulators would face a financial penalty of up to 5% of turnover derived from “regulatory functions” when fined. Fines would also potentially involve significant reputational damage for Approved Regulators. If fined, Approved Regulators will be required to provide information relating to their turnover.	
	One-off (Transition)	Yrs		
	£ Negligible			
	Average Annual Cost (excluding one-off)			
	£ Negligible		Total Cost (PV)	£ Negligible
<p>Other key non-monetised costs by ‘main affected groups’</p> <p>There will be some cost of compliance for Approved Regulators, given the possibility of a fine increases the risk in which they operate. Approved Regulators all face the same relative costs under this option (based on a potential fine of 5% of their turnover derived from “regulatory functions”). If regulators chose to pass on penalties in the form of increases in the costs of practicing certificates, the regulated bodies would ultimately bear these costs.</p> <p>Any subsequent appeals of fines would generate costs for all parties including HMCS given appeals would be heard at court. Due to the expected low volume of cases, such costs are not expected to be significant.</p>				

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by ‘main affected groups’ There is no financial incentive for the LSB to impose high penalties: fine income will be paid into the consolidated fund.	
	One-off	Yrs		
	£ Negligible			
	Average Annual Benefit (excluding one-off)			
	£ Negligible		Total Benefit (PV)	£ Negligible
<p>Other key non-monetised benefits by ‘main affected groups’</p> <p>The maximum financial penalty proposed will provide an incentive for improved regulatory performance by the Approved Regulators which in turn will give consumers confidence in the services provided. Given the deterrence effect provided, the efficiency of the regulatory system should be improved.</p>				

Key Assumptions/Sensitivities/Risks

Assumptions are:

- the proposed maximum financial penalty will act as a deterrent;
- the circumstances in which the maximum will be used will be exceptional; and
- the level of any financial penalty imposed will always be proportionate to any breach

Price Base Year N/A	Time Period Years N/A	Net Benefit Range (NPV)		NET BENEFIT (NPV Best estimate) £ Negligible		
What is the geographic coverage of the policy/option?				England & Wales		
On what date will the policy be implemented?				January 2010		
Which organisation(s) will enforce the policy?				The LSB		
What is the total annual cost of enforcement for these organisations?				£ NIL		
Does enforcement comply with Hampton principles?				Yes		
Will implementation go beyond minimum EU requirements?				Yes.		
What is the value of the proposed offsetting measure per year?				£ NIL		
What is the value of changes in greenhouse gas emissions?				£ NIL		
Will the proposal have a significant impact on competition?				No		
Annual cost (£-£) per organisation (excluding one-off)			Micro	Small	Medium	Large
Are any of these organisations exempt?			N/A	N/A	N/A	N/A
Impact on Admin Burdens Baseline (2005 Prices)				(Increase - Decrease)		
Increase of	£ Negligible	Decrease	£ Negligible	Net	£ Negligible	
Key:				Annual costs and benefits: Constant Prices		
				(Net) Present Value		

Evidence Base (for summary sheets)

Introduction and Background

1. The LSB is the organisation created by the LSA and is responsible for overseeing legal regulators, (referred to as the Approved Regulators in the LSA) in England and Wales. The LSB's mandate is to ensure that regulation in the legal services sector is carried out in the public interest; and that the interests of consumers are placed at the heart of the system. The LSA gives the LSB and the Approved Regulators the same Regulatory Objectives¹ and a requirement to have regard to the Better Regulation Principles². Compliance by the LSB and the Approved Regulators with the Regulatory Objectives, other requirements in the LSA and other statutes will help to ensure that this mandate is achieved.
2. The LSA gives the LSB a range of enforcement powers to exercise over Approved Regulators where their acts or omissions threaten the Regulatory Objectives. Its powers include the ability to impose a financial penalty upon Approved Regulators. This was considered to be an important part of a regulator's toolkit and necessary in the interests of the LSB having the greatest possible flexibility to use the most appropriate sanction at any given time. This was debated during the passage of the Legal Services Bill and therefore the merits of this power itself are not considered in this Impact Assessment.
3. Section 37(4) of the LSA requires the LSB to make rules prescribing the maximum amount of a penalty which may be imposed under Section 37. A financial penalty can be imposed where an Approved Regulator has failed to comply with any requirement imposed on an Approved Regulator by: (i) the LSB's internal governance rules (the separation of the regulatory and representative functions) made under Section 30 of the LSA; (ii) directions given by the Board under Section 32 of the LSA (for example for a failure to comply with any requirement of the LSA); and (iii) Section 51 of the LSA (requirements in relation to practising fees) or by any rules that the LSB may make under that section. Each of these requirements in the LSA is designed to ensure that the legal services market operates in a way which gives consumers confidence in the way that legal services are regulated.

¹ The Regulatory Objectives are

- (a) protecting and promoting the public interest;
- (b) supporting the constitutional principle of the rule of law;
- (c) improving access to justice;
- (d) protecting and promoting the interests of consumers;
- (e) promoting competition in the provision of services such as are provided by authorised persons;
- (f) encouraging an independent, strong, diverse and effective legal profession;
- (g) increasing public understanding of the citizen's legal rights and duties;
- (h) promoting and maintaining adherence to the professional principles.

² The five principles of good regulation are proportionality, accountability, consistency, transparency and targeting as set out in Section 3(3) of the LSA

4. In summary, the financial penalty will help prevent Approved Regulators from:
(i) acting in a way so that their regulatory functions are prejudiced by their representative functions; (ii) using practising certificate fees in an inappropriate manner; and (iii) acting in a way that that is inconsistent with the LSA and in particular the Regulatory Objectives.
5. The rules that the LSB is required to make under Section 37(4) prescribe the maximum amount of a penalty. This is therefore the amount of a penalty that the LSB can impose in a worst case scenario. The LSB is under an overarching duty to act proportionately and this duty will be met each time the LSB seeks to impose a financial penalty. As an additional safeguard, the LSA also sets out the grounds on which an Approved Regulator is able to appeal to the High Court against the decision of the LSB to impose a financial penalty.

Scope of the Impact Assessment

6. The scope of this Impact Assessment is limited to the amount of the maximum financial penalty. The decision to give the LSB the power to impose a penalty on the Approved Regulators has previously been discussed in consultation documents, independent reviews, White Papers and parliamentary debates. The LSA requires the LSB to make rule about what the maximum amount of such penalty should be. This Impact Assessment deals solely with what this maximum amount should be.

Scope of the proposals

7. In summary, the proposal is that the maximum amount should be an amount equal to 5 per cent. of all income which the Approved Regulator has derived from the exercise of its “regulatory functions” (as defined in Section 27 of the LSA) in respect of its most recent accounting period.

Stakeholder groups and Organisations in the scope of the proposal

8. The 10 current Approved Regulators and any new Approved Regulators will be subject to the financial penalty provisions. The current Approved Regulators are the Law Society, the Bar Council, the Council for Licensed Conveyancers, the Institute of Legal Executives, the Chartered Institute of Patent Attorneys, the Institute of Trade Mark Attorneys, the Faculty Office, the Association of Law Costs Draftsmen, the Association of Chartered Certified Accountants (“ACCA”) and the Institute of Chartered Accountants of Scotland (“ICAS”).
9. The LSB recognises that it may be possible for an Approved Regulator to choose to pass on the cost of any financial penalty to those it regulates by way of an increase in the cost of a practising certificate. This in turn may result in this cost being passed on to consumers. The extent to which passthrough at both levels occurs will depend on competitive pressures within the relevant markets.
10. The ability for the Approved Regulator to pass on the cost of the financial penalty (irrespective of what the level of the penalty is) is inherent in the structure of the LSA and is not something that the LSB has control over. Ultimately, whether an Approved Regulator will pass on the cost to its regulated community will depend on the nature of the regulated community.

11. Ultimately, the LSB believes that the use of a financial penalty is likely to be a rare event but that if the cost of any financial penalty is passed on in this way, any cost to the consumer is likely to be very small. Table 1 at paragraph 35 below sets out the likely cost to those regulated by an Approved Regulator in the event of the **maximum** penalty being set in accordance with Option 2, the preferred option.

Policy Rationale for Proposals

12. The LSA requires the LSB to make rules prescribing the maximum amount of a penalty which may be imposed under Section 37. The circumstances in which such a penalty can be imposed are set out above.
13. The LSB is mindful that it should set an appropriate maximum that is not too low, (as this may not have sufficient deterrent value) but not too high (as this may impose disproportionate costs on smaller Approved Regulators). The preferred option is one that is considered to provide an appropriate balance between these two concerns, and is considered by the LSB to be the most proportionate given its role as an oversight regulator and the requirements of the LSA.

Economic Rationale

14. The conventional economic approach to Government intervention is based on efficiency or equity arguments. Government intervenes if there is a perceived failure in the way a market operates (“market failures”) or if it would like to correct existing institutional distortions (“government failures”). Government also intervenes for equity (fairness) reasons. In this case, intervention would be justified primarily on efficiency grounds.
15. Intervention by the LSB in the event of non compliance by imposing a financial penalty of sufficient deterrent value is likely to incentivise the Approved Regulator to improve compliance and therefore their overall efficiency and performance. This should improve welfare overall, assuming the compliance costs incurred by the Approved Regulators are outweighed by the value of efficiency gains made to the regulatory system.

Cost Benefit Analysis

16. The Consultation Paper considered a number of options for setting the amount of the maximum financial penalty. One option discussed was whether the maximum amount should be set at an amount equal to 10 per cent. of an Approved Regulator’s income. This formulation is one that is commonly used by economic regulators, especially in the utilities sector. This option was largely discounted in the Consultation Paper (and subsequently by respondents) because it was recognised that the LSB’s relationship with the Approved Regulators is very different to that of an economic regulator. The preferred option that was put forward in the Consultation Paper was Option 1 outlined below.
17. Response to the Consultation Paper suggested that the LSB look at the maximum fining powers given to the Legal Services Complaints Commissioner (the “LSCC”). This power effectively limits the LSCC maximum fine to £1 million by using a formula that states the maximum amount is the

lesser of: (i) £1 million; and (ii) 1 per cent. of the bodies total income from all sources³. After consideration, this option was not perused.

18. However, in light of consultation responses, and after further consideration, the LSB has developed a further option, set out as Option 2 below. For the reasons explained in this Impact Assessment, Option 2 is now the preferred option, which will be implemented.

BASE CASE / OPTION 0 (“Do Nothing”)

19. The options that the LSB has focussed on deal with how the LSB will set the maximum amount of a penalty. The LSA requires the LSB to make rules prescribing the maximum amount. Therefore, the do nothing base case is presented as hypothetical only. The two options presented below are compared to this hypothetical base case. There are no costs or benefits associated with the base case.

OPTION 1

Description

20. As set out above, this option was the one proposed in our original Consultation Paper. This proposed setting a maximum penalty of the greatest of:

- an amount equal to £250 per individual that the Approved Regulator regulates;
- an amount equal to £5,000 per entity that the Approved Regulator regulates; or
- £10 million.

Costs

Financial costs

21. The maximum penalty under this option could result in a maximum penalty of around £28 million⁴ for the Law Society and £10 million⁵ for the Bar Council. This option was not widely supported in our consultation. Respondents believed that the maximum amount was too large and that in some circumstances could potentially bankrupt some of the smaller Approved Regulators.

22. In instances where an Approved Regulator was fined, in addition to the financial costs they would also face reputational damage. This reinforces the financial incentives provided by the penalty itself.

Administrative costs

23. The LSB would incur some ongoing costs in instances when it would have to impose the penalty. These could be significant given the relative complexity of

³ Legal Complaints Commissioner (Maximum Penalty) Order 2004 (SI 2004/ 2758)

⁴ [The consolidated report and financial statements for The Law Society as at 31 December 2008](#) state (at page 5) that there were 112,246 solicitors holding practising certificates as at March 2009. If you multiply this figure by £250 you reach approximately £28 million.

⁵ The number of individuals that the Bar Council currently regulates is approximately 15,000. 15,000 multiplied by £250 equals £3.75 million. This means that the £10 million threshold would apply.

the penalty structure (compared to Option 2). Similarly, if fined Approved Regulators would face costs given they would be required to provide information relating the number of individuals and entities they regulate, in addition to their turnover.

24. An argument could be made that the imposition of a relatively large penalty (such as this option would allow) might lead to a greater number of appeals by Approved Regulators which in turn could lead to greater costs for the judicial system. There is no evidence that such impacts would generate significant costs for HMCS, particularly given it is not envisaged that financial penalties will be used on a regular basis and the LSB does not think that its selection of the appropriate level for the maximum penalty should be affected by this consideration.

Compliance costs

25. Approved Regulators are likely to incur compliance costs to reduce the risk of receiving a penalty; the potential penalty proposed under this option would have significant deterrent value.

Distributional costs

26. Given this option in effect provides a lower bound (of £10 million) for the maximum fine, in relative terms (compared for example to their turnover) the potential fine a small Approved Regulators may face is higher than the fine a large Approved Regulators may face. Any compliance costs borne by Approved Regulators as a result of the penalty could be significant for, and may impact disproportionately on, smaller Approved Regulators.
27. As mentioned above, it is possible that an Approved Regulator may choose to pass on the cost of any financial penalty to those it regulates by way of an increase in the cost of the practising certificate. This in turn may result in this cost being passed on to consumers. This may generate distributional impacts, although the effect of such impacts is uncertain.
28. If the Approved Regulator chose to pass on the amount of the financial penalty to their regulated community, this in itself would incentivise members of the profession to put pressure on their Approved Regulator to improve their compliance. If a number of financial penalties were passed through by an Approved Regulator this may in itself incentivise members of the professions to switch to an alternative regulator (if one was available). All these factors should ultimately help drive regulatory compliance.

Benefits

Financial benefits

29. Any financial penalty imposed on an Approved Regulator by the LSB is paid into the Consolidate Fund. There is therefore no incentive on the LSB to impose a large penalty other than the penalty should be an incentive to change behaviour.

Efficiency benefits

30. The benefit of this option is that it sets a maximum penalty with significant deterrent value. This should provide benefits for firms and consumers within the regulatory framework covered, given the effectiveness of the regulatory

system should be improved. The methodology also allows for the maximum penalty to increase as the Approved Regulators scope of regulatory functions increase.

Net Impact

31. It has not been possible to quantify the costs and benefits set out above, in line with the uncertainties present. However, it is considered that this option would result in a maximum penalty which could ultimately be too large for the smallest Approved Regulators. This conclusion is supported by consultation responses: all but one respondent had serious reservations about this proposal. This option would also impose extra administrative costs on all Approved Regulators, and on the LSB, compared to Option 2. For these reasons, this option is no longer the preferred option.

OPTION 2

Description

32. This option is to frame the maximum penalty as an amount equal to 5 per cent. of all income which the Approved Regulator has derived from the exercise of its “regulatory functions” (as defined in Section 27 of the LSA) in respect of its most recent accounting period.

33. This option will lead to a smaller maximum amount than that proposed under Option 1, particularly for the smallest Approved Regulators. Both options provide a maximum amount that the LSB can impose, but it is noted that in deciding what penalty to impose the LSB would always be under a duty to act proportionately, taking into account the particular circumstances of each case.

Costs

Financial costs

34. From the Approved Regulators’ perspective, this option doesn’t give them a certainty of capping the maximum penalty at a specific amount; rather the potential fee depends on turnover. Any fines would represent a cost to Approved Regulators.

35. An illustration of the cost of this proposal to those Approved Regulators who have publicly available accounts for the year ended 31.12.08 is set out in Table 1 below. This table also sets out the per capita cost to each member of the profession if the Approved Regulator chose to pass the penalty through as an increase in the practising certificate fee.

Table 1: Possible financial implications of Option 2 fee structure

Approved Regulator	Approximate income from “regulatory functions” derived from audited accounts FYE 31.12.08	Proposed maximum on basis of 5% formula	Number of Authorised Persons⁶	Per capita cost if full penalty passed through
The Law Society	£108 million	£5,400,000	108,407	£50.00
The General Council of the Bar	£6,100,000	£305,000	15,030	£20.00
Institute of Legal Executives	£6,500,000	£321,000	7,488	£43.00
Council for Licensed Conveyancers	£1,223,000	£61,000	1,034	£59.00
Institute of Trade Mark Attorneys	£582,000	£ 29,000	844	£35.00

Note: Accounting information for the Master of Faculties, the Chartered Institute of Patent Attorneys and the Association of Law Costs Draftsmen not publicly available. ACCA and ICAS are also excluded because they were not undertaking regulatory functions during the year ending 31.12.08.

36. In instances where an Approved Regulator was fined, in addition to the financial costs they would also face reputational damage. This reinforces the financial incentives provided by the penalty itself.

Administrative costs

37. The LSB would incur some minor ongoing costs in instances when it would have to impose the penalty. Given the proposed structure is simpler than under Option 1, these costs would be lower. Similarly, Approved Regulators would face costs if fined as they would be required to provide turnover information. These costs would also be lower than under Option 1.

38. As with Option 1, an argument could be made that the imposition of a relatively large penalty (such as this option would allow) might lead to a greater number of appeals by Approved Regulators which in turn could lead to greater costs for the judicial system. There is no evidence that such impacts would generate significant costs for HMCS, particularly given it is not

⁶ See page 6 of the LSB Business Plan 2009/10
http://www.legalservicesboard.org.uk/news_publications/publications/pdf/business_plan_2009_10.pdf

envisaged that financial penalties will be used on a regular basis and the LSB does not think that its selection of the appropriate level for the maximum penalty should be affected by this consideration.

Compliance costs

39. A potentially large penalty such as proposed under this option would have significant deterrent value. One result of this may be that Approved Regulators face increased compliance costs to ensure that a financial penalty is not imposed against them. Unlike Option 1, there is no lower bound on the maximum fine: the maximum is proportional to turnover. This means that all Approved Regulators face the same relative risks, and would be expected to bear the same relative costs, regardless of their size.

Distributional costs

40. It is possible that an Approved Regulator may choose to pass on the cost of any financial penalty to those it regulates by way of an increase in the costs of the practising certificate. This in turn may result in this cost being passed on to consumers. The final column of Table 1 illustrates the per capita cost to each member of the profession if the Approved Regulator chose to pass the penalty through as an increase in the practising certificate fee. This would generate distributional impacts on the regulated bodies and their customers, although the effect of such impacts is uncertain.

41. If the Approved Regulator chose to pass on the amount of the financial penalty to their regulated community, this in itself would incentivise members of the profession to put pressure on their Approved Regulator to improve their compliance. If a number of financial penalties were passed through by an Approved Regulator this may in itself incentivise members of the professions to switch to an alternative regulator (if one was available). All these factors should ultimately help drive regulatory compliance.

Benefits

Financial benefits

42. Any financial penalty imposed on an Approved Regulator by the LSB is paid into the Consolidate Fund. There is therefore no financial incentive on the LSB to impose a large penalty, other than the penalty should be an incentive to change behaviour.

Efficiency benefits

43. This option sets a maximum penalty with a significant deterrent value. This should provide benefits for firms and consumers within the regulatory framework covered, given the effectiveness of the regulatory system should be improved. The methodology also allows for the maximum penalty to increase as the Approved Regulators scope of regulatory functions increase.

44. The use of a figure based on a percentage of regulatory income follows the model that is already in use by the LSCC and allows for a maximum which is proportionate to the relative size of the different Approved Regulators.

45. However, the figure of 5 per cent. (rather than the 1 per cent. that the LSCC can impose) is considered appropriate because the roles of the LSB and the LSCC are very different. The LSCC regulates just one sub-section of

activities (complaints). It is the LSB's responsibility to oversee the regulation of all regulatory activities of the Approved Regulators and to ensure that sufficient sanctions and deterrents are in place to deter major systemic regulatory failure, and to ensure its rapid correction if and when it occurs. This is an important consideration with the introduction of Alternative Business Structures.

46. The option also recognises that the 10 per cent figure often used by economic regulators is not appropriate for dealing with the scale of activities of the Approved Regulators. However, the option does recognise that not limiting the penalty to an absolute maximum (as the LSCC does with its absolute maximum of £1 million) gives the flexibility for the level of the penalty to increase in line with the increase in an Approved Regulators "regulatory functions".

Net Impact

47. As with Option 1, it has not been possible to quantify the costs and benefits set out above, in line with the uncertainties present. However, it is considered that this option would result in a maximum penalty that would be appropriate for all Approved Regulators, regardless of their size. This option would also minimise the administrative costs on all Approved Regulators, and on the LSB. For these reasons, this option is the preferred option.

SUMMARY OF OPTIONS

48. The LSB prefers Option 2. The reasons for this are as follows:

- the use of a figure based on a percentage of regulatory income follows the model that is already in use by the LSCC and allows for a maximum which is proportionate to the relative size of the different Approved Regulators;
- the figure of 5 per cent. (rather than the 1 per cent. that the LSCC can impose) is considered appropriate because the LSB is dealing with a broader range of activity than the LSCC and would provide sufficient deterrent value;
- not limiting the penalty to an absolute maximum (as the LSCC does with its absolute maximum of £1 million) or minimum (such as £10 million in Option 1) gives the flexibility for the level of the maximum penalty to be clearly linked to the scope of an Approved Regulators "regulatory functions". The LSB believes that this flexibility is important as the regulatory regime for Alternative Business Structures develops;
- the methodology gives a maximum amount which, by sitting between the maximum that can be imposed by the LSCC and the maximum that can be imposed by most economic regulators, recognises the unique oversight relationship between the LSB and the Approved Regulators;
- the proposed structure is simple, which will minimise the administrative costs that both the LSB and Approved regulators would bear in any instances when a fine is imposed.

49. It should be remembered that this policy only sets a maximum amount. The LSA requires the LSB to act proportionally and as a result the actual penalty imposed will be considered on a case by case basis.

Enforcement and Implementation

50. The policy adopted will be implemented by a statutory instrument which can only be made with the consent of the Lord Chancellor.

51. The LSB will be the body who enforces the policy.

Specific Impact Tests

52. Extensive Impact Assessments were carried out in the process of the Legal Services Bill's progress through Parliament⁷. The LSA requires the LSB to make rules prescribing the maximum amount a financial penalty.

Rural proofing

53. The LSB's policy on financial penalties and the amount of the maximum amount of any penalty is not expected to have a specific impact on rural areas.

Environmental tests

54. There is no impact expected on the environment.

Competition Assessment

55. We would expect our enforcement strategy and processes to have a positive effect on competition. Compliant Approved Regulators should lead to a regulatory framework which enables providers of legal services to innovate and develop services that better reflect the needs of consumers.

Sustainable Development

56. There is no impact expected on sustainable development.

Small Firms Impact Test

57. The maximum financial penalty rules will not apply to small businesses. However, as noted elsewhere in this Impact Assessment, it is possible that an Approved Regulator may choose to pass on the cost of any financial penalty to those it regulates by way of an increase in the cost of a practising certificate. If this occurred on a regular basis it could have a disproportionate impact on smaller law firm businesses. In mitigation, the LSB believes that the use of a financial penalty is likely to be a rare event and if it is used, the maximum it proposes (which is the maximum and is therefore not indicative of the likely average level of a penalty) when coupled with the LSB's overarching duty to act proportionately, is not large enough to cause a significant disproportionate impact on small firms.

Legal Aid and Justice Impact Test

58. The LSB's policy is not expected to have a specific impact on legal aid and justice.

⁷ <http://www.official-documents.gov.uk/document/cm68/6839/6839.pdf>

Human Rights

59. There are specific requirements on the LSB to make rules concerning the making of oral and written representations in relation to the exercise of certain of the LSB's enforcement functions. Although there is no specific requirement for the LSB to make such rules in relation to the imposition of financial penalties, the LSB has decided that the same rules should apply as those that apply to its other enforcement functions.
60. Section 39 of the LSA provides a mechanism for Approved Regulators to appeal to the High Court against aspects of a decision to impose a financial penalty.

Freedom of Expression Audit

61. The LSB's policy is not expected to have a specific impact on Freedom of Expression.

Privacy Impact Test

62. The LSB's policy is not expected to have a specific impact on privacy.

EIA

63. Because the LSB is an oversight regulator there is no direct impact on individuals. However, if the LSB achieves its intended outcomes, there will be a general improvement in the standard of regulation and the approach taken to it which we would expect to have a positive impact generally on the provision of legal services to all consumers, and to provide increased opportunities for all groups of those being regulated.
64. It is possible that an Approved Regulator may pass on the cost of any financial penalty to those it regulates by way of an increase in the cost of a practicing certificate. If this occurred on a regular basis it could have a disproportionate impact on solicitors, barristers and any other approved persons on relatively moderate incomes. This may have some impact on diversity given that a high proportion of these approved persons are likely to be Black or Minority Ethnic. However it will be for the Approved Regulator to determine how it passes on the cost of the financial penalty to those it regulates. The LSB believes that the use of a financial penalty is likely to be a rare event and that if it is used, the maximum it proposes, when coupled with the LSB's overarching duty to act proportionately, is not significant enough to cause such an impact.

Specific Impact Tests: Checklist

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Annexes

None