

John Wotton
President
The Law Society
113 Chancery Lane
London
WC2A 1PL



**LEGAL SERVICES
BOARD**

The Chairman's Office
Legal Services Board
7th Floor
Victoria House
Southampton Row
London WC1B 4AD

T 020 7271 0043
F 020 7271 0051

www.legalservicesboard.org.uk

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Regulatory independence 2011: Final assessment and section 55 information requirement

Thank you for completing the abridged dual self-certification of regulatory independence and providing most of the requested documentation to enable the LSB to make a judgement on the Law Society and SRA's compliance with the requirements of the Internal Governance Rules (IGRs) and the relevant sections of the Legal Services Act 2007 (the Act).

I should record my thanks to you, Charles Plant and your respective Chief Executives for the personal efforts which I know you all put into developing these new arrangements. This letter sets out the Board's final decisions and the rationale for them. It necessarily highlights the outstanding issues where more work and assurance is needed, but this is in no way to understate the progress that has been made.

In our final response to the 2010 regulatory independence assessment exercise we concluded that you were not compliant with the IGRs. However, given your progress during that year and commitments made, we did not consider it appropriate to commence formal enforcement action. We noted that you had made some progress to make in the provision of shared services agreements. We also said that you needed to amend the General Regulations so that the Law Society Council would not be able to dismiss SRA board members without the LSB's concurrence. In addition, we had concerns about the complexity of some of the arrangements and we also noted a number of theoretical risks to the SRA's independence. We accepted the assurances made by the Law Society and the SRA and their commitment to review the arrangements during 2011. But we also committed that the Board itself would identify areas of risk to the delivery of independent regulation and target those areas during 2011.

Our 2011 IGR exercise revealed that work had not been completed on the shared services agreements, that the suggested amendments to the General Regulations had not been

made and that you had not reviewed the operation of the existing oversight and governance arrangements as had been promised. The SRA in its draft IGR submission to the LSB made it clear that, in its view, many of the risks to independence arising from the complexity of the arrangements between the two organisations had in fact materialised. The Law Society did not accept this view. The Board considered that this disparity of view was in itself a matter of some considerable concern. However, we deemed it unnecessary to reach a view on the substance of the soon to be superseded governance arrangements, given that, to the credit of both the Law Society and the SRA, new arrangements were to be proposed.

The LSB agreed to provide the Law Society and the SRA with an extended period to devise these new arrangements. We also agreed to finalise our 2011 assessment exercise based on the provision of an abridged regulatory independence certificate, all relevant documents and answers to specific issues raised by the LSB and the concerns detailed by the SRA to the LSB in its draft IGR return. Although, to our surprise and disappointment, the Law Society and SRA both expressed an unwillingness to provide the LSB with the Council and Board documents relating to the agreement, we are confident that the documents provided to the LSB (which will be published) do provide us with enough information to make a judgement on the potential for the Law Society Council's proposed arrangements to deliver compliance with the IGRs and the Act. We are clear, however, that a firm judgement can only be delivered once the arrangements are fully operational and shown to be delivering independent regulation in practice. Our judgement is therefore primarily framed in a forward looking way to ensure that we can have proper assurance on this point.

Overall conclusion

We conclude that arrangements detailed in the document 'Law Society / SRA proposals on Governance' (the "new arrangements") are potentially capable of delivering compliance with the IGRs. We also welcome the fact that you are on track to deliver a lay majority in January 2013 as previously agreed.

However, as the new arrangements are untested, unimplemented and relatively complex we are unable to determine definitively at this stage that the arrangements deliver independent regulation in practice. Hence we cannot conclude that the Law Society internal governance arrangements are currently fully compliant with the IGRs. **Annex A** details the rationale for this conclusion based on our assessment for each part of the IGR schedule.

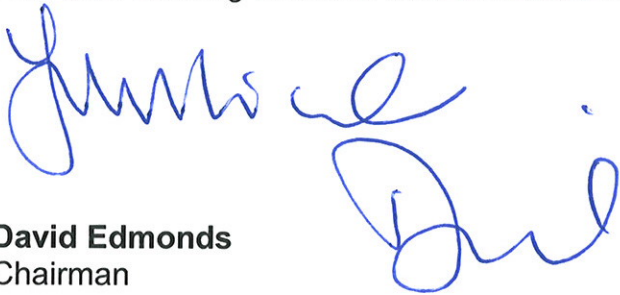
Considering this uncertainty, the fact that the current arrangements are not compliant with the IGRs, the serious concerns about independence of regulation expressed during this year's IGR exercise, the failure to deliver on all commitments from last year; and your reticence to provide Board and Council papers to assist the LSB reach a conclusion on the new arrangements, the Board has therefore decided formally to require you to provide periodic information regarding the implementation and operation of the Business and Oversight Board and the new arrangements. This information is required pursuant to section 55 of the Act and a Notice specifying our exact requirements is at **Annex B**.

The LSB requires this information to satisfy itself that the new arrangements are being implemented in a way that ensures regulatory independence and are implemented in line with the timetable detailed in the letter dated 23 November from the Law Society and in the letter dated 25 November from the SRA. We have concluded that this represents a proportionate requirement considering the risks to independent regulation and issues identified above and in annex A.

The requirement is time limited. We intend to complete the monitoring in nine months and, if we are confident that the arrangements are being introduced appropriately, we may suspend monitoring before that date.

The LSB has no wish to revisit such issues in future years and is as keen as we know the Law Society and SRA are that the new arrangements work in practice. The independence of regulation is a central tenet of the Act. The Act was passed four years ago, our independence rules were made two years ago. If next year these arrangements are found not to be operating satisfactorily in practice, we will have to consider whether enforcement action would provide an appropriate measure to deliver independent and effective regulation.

I am also sending this letter and enclosures to Charles Plant.

A handwritten signature in blue ink, appearing to read 'David Edmonds', with a large, stylized 'D' and 'E'.

David Edmonds
Chairman

Happy Christmas!

Annex A: Internal Governance Rules – Law Society and SRA final assessment 2011

1. Analysis of the new arrangements provided to the LSB by the Law Society in its letter dated 23 November and by the SRA in its letter dated 25 November during the 2011 exercise.

Part 1: Governance

2. The IGRs section on governance requires, amongst other things, that all regulatory functions are delegated to a body without any representative functions, that this body is governed by a board or equivalent structure, that the majority of the board members must be lay and the selection of a chair of the board must not be restricted by virtue of any legal qualification that person may or may not hold.
3. The 2010 regulatory independence assessment accepted the Law Society and the SRA's revised action plan that committed to achieving parity of lay / non-lay members by January 2012 and a lay majority in January 2013. We are pleased that you are on track with this action plan. We also note that you have changed the General Regulations so that it is possible for a lay person to chair the SRA from January 2013.
4. There remained a number of questions regarding the delegation of regulatory functions from the Law Society to the SRA and the Business and Oversight Board. We understand that these have been resolved at the December Law Society Council meeting on 14 December 2011. We are obviously unable to pass judgement on how they are working in practice.
5. Considering the above we are unable to conclude that the operation of the Law Society / SRA arrangements is currently compliant with the IGRs. However, as you have made the required changes to the General Regulations and appear to be on track with the action plan to deliver a lay majority in January 2013 we consider that, providing the changes are implemented within an appropriate timescale, this is an acceptable resolution of this particular issue.
6. In the next assessment round, we will review the changes made to the General Regulations to assess compliance with the IGRs in delivering independent regulation in practice.

Part 2: Appointments

7. Our rules require that regulatory board members' appointments, reappointments, appraisal and discipline must be demonstrably free of undue influence from people with representative functions. Our guidance suggests that the regulatory board should have, at the least, a strong involvement in recruitment of its members and that the Chair of the regulatory board should always sit on the panel to appoint ordinary members. Decisions on remuneration of regulatory board members must respect the principles of regulatory independence and should not be controlled wholly or mainly by persons with responsibility for representative functions. Except in the circumstances set out in paragraph 11 below, no person appointed to the

regulatory board can be dismissed without the concurrence of the LSB. Regulatory board members cannot also be responsible for any representative functions.

8. The new agreement between the Law Society and the SRA includes reforms to the remuneration committee which will introduce parity between Law Society and SRA members. The old arrangements only allowed for one member of the regulatory board to sit on the remuneration committee compared to two Law Society Council members and a minimum of four solicitor members. Since it was this committee that determined the compensation payable to regulatory board members and other payments to regulatory board executives, the extent that such arrangements complied with the requirement to respect the principle of regulatory independence for remuneration of regulatory board members was questionable. The new arrangements for remuneration do have the potential to comply with these requirements.
9. Our understanding of the new Business and Oversight Board is that it will be responsible for forming a sub-committee to advise the Law Society Council on the policy in relation to appointments / reappointments to the SRA board. This role is currently held by the Law Society's Management Board, a board that can consist of twelve members of which at least nine must be council members. Currently the Management Board consists of ten members, including nine Law Society Council members and the chief executive of the Law Society. The current arrangements as drafted in the General Regulations cannot be said to comply with our requirement that the appointment process must be demonstrably free of undue influence from those with representative functions.
10. The Law Society informed us in its response on 23 November that in practice, appointments to the SRA Board have been governed by a panel with an independent chair, a Law Society and SRA representative and an accredited assessor. Such a process does appear to comply with the requirements of the IGRs. Yet the General Regulations were not codified to reflect this approach. The new arrangements do provide for the involvement of SRA Board members and, providing they are implemented in the manner suggested in the Law Society and the SRA's responses to the questions from the LSB (annex 3 of the letter from the SRA dated 25 November), then it is likely that the new arrangements for the appointment and reappointment of SRA board members will be compliant with the IGRs.
11. The new oversight protocol allows the Law Society Council to decide whether or not its intervention is required to change the SRA Board. Our rules state, that unless the Law Society was exposed to any material legal liability then no regulatory board member can be dismissed without the LSB's concurrence. The Law Society in its letter dated 23 November 2011 and the SRA in its letter dated 25 November have assured the LSB that they are aware of this requirement in the IGRs and accept that the Law Society would be in breach of the IGRs if the Law Society Council attempts to dismiss SRA Board members in the absence of material legal liability.

12. Considering the above, we are unable to conclude unequivocally that the Law Society and the SRA's codified arrangements on appointments, remuneration and dismissal were in compliance with the requirements of this IGR section during 2011. However we believe that the new arrangements, if implemented in line with the assurances provided in annex 3 of the letter from the SRA dated 25 November, do have the potential to comply with this section of the IGRs.

Part 3: Strategy and resources etc

13. The IGRs require that individuals and / or organisations performing regulatory functions must have the freedom to define their own regulatory strategy, have access to the financial and other resources required to meet that strategy, have control over the management of those resources and the ability to govern all internal processes and procedures. The regulatory body must be able to do anything within its allocated budget to carry out its regulatory functions. Budget approval mechanisms must be transparent and fair and, if provided with shared services, there must be transparent and fair dispute resolution mechanisms.
14. In our final response to the 2010 IGR assessment, we noted that the key principles in relation to budgets and resources appeared fit for purpose. However, as service level agreements and protocols related to the shared services to be provided by the Law Society to the SRA had not been finalised, we were unable to conduct any analysis of their content and make an assessment on whether the arrangements complied with the requirements of the IGRs.
15. Our 2011 exercise asked for an update on the production of the detailed service level agreements. It became apparent that, while work was advanced on the production of some agreements, it had not been completed. Indeed, there were questions over the appropriateness of the shared services provided by the Law Society to the needs of the SRA. These questions included concerns about the provision of appropriately differentiated services and a number of shortcomings and insufficiencies in the services received.
16. The new arrangements attempt to address these concerns and provide the SRA with more confidence in the system by which it is provided with shared services. Our review of the new arrangements for the provision and governance of shared services suggests that they are capable of being compliant with the IGRs. The membership of the Business and Oversight Board includes a significant number of SRA Board members and shared services will be delivered by a new post, the Director of Organisation Services, reporting to that Board, rather than to the Chief Executive of the Law Society.
17. The response provided by the Law Society in the annex to its letter dated 23 November to our question on the ability of the SRA to seek particular services from an alternative provider therefore has the potential to be acceptable. Formal delegation to the Business and Oversight Board to consider such a request from the SRA should allow for balanced consideration on the matter in question and the rationale for the request. However, we note that this is not in line with our illustrative

guidance on the matter, which expects complete freedom of the SRA to seek an alternative provider of shared services where it believes its independence and / or effectiveness is being compromised or prejudiced by the Law Society. Therefore, it remains an open question as to whether the arrangements will be compliant in practice.

18. In terms of access to resources and control of strategy, the old arrangements led to situations where there was confusion over the role of a number of Law Society constitutional bodies. The SRA was required to produce business cases for Law Society Boards whose role in such matters, on occasions, it thought inappropriate. It is questionable how such examples could have been compliant with the requirements of part 3 of the IGR schedule. The new arrangements are clearer in terms of who would be responsible for approving additional monies in year as well as overall budget approval process and other relevant issues.
19. Considering the above, we have concluded that in relation to part 3 of the IGR schedule the arrangements in place during 2011 could not be reasonably said to have achieved complete compliance in practice with the requirements of part 3 of the IGR schedule. The two bodies failed to reach agreement on shared services agreements, there were concerns about the appropriateness of the shared services provided to the SRA to meet its strategy and a lack of transparency in budget approval and reporting.
20. The new arrangements address these issues in a comprehensive manner. Necessarily, until they are implemented, there can be no guarantee that they will succeed, but we do believe that they are capable of resolving the questions of independence that have arisen during this year.

Part 4: Oversight

21. The IGRs require that oversight arrangements must not impair the independence and effectiveness of the regulatory body and that they must be transparent and proportionate. The oversight arrangements must also prohibit the Law Society from intervening or making directions about the management or the performance of regulatory functions by the SRA unless the LSB has concurred.
22. The IGRs state that the arrangements the Law Society adopts for the oversight of the SRA must be proportionate and transparent. Proportionality is defined with a reference to the risk of LSB intervention and our published statement on compliance and enforcement. We made it clear during our initial assessment in 2010 that we thought the oversight arrangements were complex, that we had concerns about how they would operate in practice and we questioned whether there were adequate safeguards to prevent undue influence. The Law Society did not accept our assessment and felt the arrangement provided for appropriate safeguards in practice. However the Law Society in its letter dated 7 September 2010 did commit to reviewing the budgetary and support services oversight arrangements in early 2011 and report to the LSB the conclusions of that review.

No conclusions were reported to the LSB, either separately or in the course of initial submissions in the 2011 assessment round.

23. During this year's process, it became apparent that the SRA felt it had been subject to repeated excessively detailed requests for information about regulatory policies and procedures and that there was confusion about the role of the different Law Society Boards in conducting oversight of the SRA. However, given the Law Society and SRA's willingness to conduct work to review and revise the existing oversight arrangements we did not seek to assess whether the existing arrangements were leading to breaches of the IGRs. It is clear that questions remain about whether the oversight arrangements complied in practice with our rules during 2010 and 2011.
24. The new arrangements and oversight protocol appear to be transparent, although this will only become clear when they are operational. In any event, we remain concerned about whether they will be proportionate in practice. This is because the oversight protocol merely sets out the framework in which oversight will be conducted: it does not determine the behaviours of those involved in the oversight of the SRA.
25. In a similar manner to the section on appointments above, the new oversight protocol allows for the Law Society Council to decide whether or not its intervention is required to redesign the regulatory arrangements. The IGRs state that arrangements must prohibit intervention or the making of directions about the management or performance of regulatory functions unless this is done with the concurrence of the Board. The Law Society in its letter dated 23 November 2011 and the SRA in its letter dated 25 November 2011 have assured the LSB that they are aware of this requirement in the IGRs. Both parties accept that the Law Society would be in breach of the IGRs should the Law Society Council attempt to redesign its regulatory arrangements – both as they operate through the SRA and/or in any more fundamental way – without the Board's concurrence. We suggest that the protocol at its next iteration is amended to reflect this clear requirement.
26. We have not reached a conclusion on whether the behaviour of the Law Society during 2010 / 2011 constituted a breach of the oversight section of the IGR schedule. We did not complete the work to do so because of the apparent willingness of both bodies to work together to reach a new settlement.

Legal Services Board

December 2011

Annex B: Information Requirement: Section 55 Legal Services Act 2007

1. This Notice is served on the Law Society ("the Society") by the Legal Services Board ("LSB") under section 55 of the Legal Services Act 2007 and requires you to provide the information set out below.
2. The Society, as approved regulator, must provide the following information to the Chief Executive of the LSB:
 - A monthly report (in PDF or Word format), on the final working day of each month commencing with the 31st day of January 2012, on the delivery and implementation of the Society / SRA proposals on governance provided to the LSB by the Society in a letter dated 23 November 2011 and by the SRA in a letter dated 25 November 2011 ("the letters"). The monthly report must be submitted by the Society with confirmation that both the CEO of the SRA and the Director of Organisation Services (once appointed) have been invited to comment on the report, together with such comments as have been provided to the Society on behalf of those individuals. Each report must, for the monthly reporting period to which it relates:
 - State what aspects of the Society / SRA proposals on governance have been implemented and assess the progress of implementation against milestones set out in the timetable in the letters. Where the delivery does not match that set out in the timetable, state why and what action has / will be taken to remedy slippage;
 - Detail any disagreement concerning the provision of shared services to the SRA by the Society including any that have been escalated to the Director of Organisation Services (once appointed) and / or the Business and Oversight Board. For each issue, state the nature of the disagreement and the outcome / progress to date for each.
 - Detail all the requests for information, including urgent requests, made to the SRA by the Society and the responses to those requests during the reporting period. For the avoidance of doubt, this will include those made in the Society's oversight capacity and in its representative roles as detailed by paragraphs 11 and 12 of the Oversight Protocol and the log of requests kept by the SRA as detailed in paragraph 13 of the oversight protocol.
 - State if the SRA has informed the Society of any instances where the SRA considered that, either in an individual case or more generally, Society requests for information made during the reporting period were disproportionate or inappropriate. This includes those instances in which the matter was discussed between the SRA Chief Executive and the Chair(s) of the Business and Oversight Board as well as those formally considered by the Business and Oversight Board and more generally in the absence of the Business and Oversight Board. Provide an explanation of the issue, each party's position – particularly that of the Society, whether / how the matter was resolved or the timetable and process for resolution.

- Detail any instances in which the Society and the SRA disagreed concerning the proper application of the Internal Governance Rules 2009 in relation to a particular issue during the reporting period, provide an explanation of the issue, each party's position, whether / how the matter was resolved or the timetable and process for resolution.
- The following documents:
 - Complete copies of the Business and Oversight Board meeting minutes, agenda and papers at the same time that they are submitted to members of that Board.
 - All supplemental papers provided to the Business and Oversight Board outside the planned schedule of meetings at the same time that they are submitted to members of that Board.
 - All papers, presentations or other documents provided to the Business and Oversight Board during the meetings within one working day of the Board meeting.
- 3. The copies of the Business and Oversight Board minutes, the agenda and papers must be sent to the Chief Executive of the Legal Services Board in PDF or Word format.
- 4. This requirement continues until such time as the ninth successive monthly report described above has been received by the LSB.
- 5. The LSB reserves the right to amend or revoke this notice, by giving further notice to the Society.

Legal Services Board

December 2011