

Application made by CILEx Regulation for approval of changes to the CILEx Compensation Fund Rules

A. Introduction

1. This is an application seeking LSB approval of changes to the CILEx Compensation Fund Rules, including a change of name to CILEx Regulation Compensation Arrangements Rules.
2. We wish to revise these rules in order to transition to a largely insurance backed compensation scheme, as opposed to the maintenance of a large fund. We consider that such an approach represents a more effective, proportionate and sustainable approach.
3. In support of this application we attach the following documents:

Annex 1: Tracked rule changes;

Annex 2: Explanatory table for each drafting change proposed;

Annex 3: Public consultations document;

Annex 4: Consultation responses analysis;

Annex 5: Draft update guidance

B. Current regulatory arrangements

4. We refer firstly to the table at **annex 2** which sets out, perhaps most clearly, what the current position is under the rules and what the proposed future position should be.
5. The CILEx Compensation Fund Rules form part of a framework of requirements intended to provide an appropriate level of protection to clients of CILEx Authorised Entities (i.e. law firms authorised by CILEx Regulation) for when things go wrong.
6. The current client protection arrangements for clients of CILEx Authorised Entities broadly operates as follows:
 - all CILEx Authorised Entities must maintain professional indemnity insurance of £2 million to ensure that clients are compensated if the firm makes a mistake in a client matter (i.e. is negligent and the client loses out as a result);
 - if an entity fails to take out that insurance and a client suffers a loss

which, although not arising solely by reason of professional negligence would have been covered by such a policy, then the client can make a claim on the Compensation Fund;

- if the managers of the entity misappropriate money or fail to account for money (e.g. steal from the client) then the professional indemnity insurance does not cover this. Instead, a Compensation Fund of £1 million¹ provides awards (at the discretion of decision makers appointed by CILEx Regulation for this purpose) of up to £500,000 per claim to any client or former client who:
 - claims within one year of discovering the problem;
 - suffers hardship as a result of the loss (this will mean in practice that many business clients including lenders cannot claim on the fund);
 - cannot claim the monies from anywhere else.

7. This application relates to proposals to change aspects of the Compensation Fund arrangements (it is not concerned with the professional indemnity insurance provisions).

C. Nature and effect of the proposed changes

The nature of the proposed changes

8. The key rule changes proposed are to introduce:
- a) means based eligibility requirements in order to make a claim under the scheme, similar to some other legal services regulators. In broad terms the proposal is to limit access to the fund to consumers and to organisations with income / turnover of less than £2 million per annum (similar to the SRA position);
 - b) an aggregate limit on the total value of claims which can be made on the Fund in respect of one law firm of £2 million (commensurate with existing practical limitations in the current scheme, see below); and
 - c) an exceptional circumstances discretion under which the time limits for the receipt of claims under the scheme can be extended.
9. We are also proposing a number of other changes to improve the clarity of the rules and to move some provisions from current guidance into the rules. These changes do not involve substantive changes of policy or approach.

¹ As set out below there is also currently insurance in place for up to £1 million to seek to protect this fund.

10. Reference is again made to the table of changes at **annex 2** which sets out in more depth the changes proposed. The changes to the rules can be found in tracked format at **annex 1**.
11. Overall we consider that the final proposals submitted will have a positive impact upon consumers. For the reasons which will follow we do not consider that the introduction of eligibility criteria and a per firm aggregate limit will in practice reduce the protections available to clients of CILEx authorised entities. It is envisaged that an insurance backed scheme will actually increase the funds available to compensate consumers in the unlikely event of multiple high-value claims being made on the scheme. This reflects the overall intention behind the review which has been to increase the sustainability of the scheme given the low number of entities currently authorised.
12. As the proposals for transitioning towards a more sustainable insurance backed compensation scheme have developed we have been mindful of the potential for reducing the protections afforded to consumers. This has resulted in some proposals being dropped and others modified in order to enhance consumer protection.
13. During the consultation we sought views on whether the compensation fund could be used to expand the protections afforded to clients of CILEx authorised entities where a firm fails to purchase the 6 year 'run-off cover'. This is insurance which firms are required by the CILEx Regulation rules to fund in order to ensure that insurance is in place for negligence claims made against the firm after it closes. In order for a grant to be made currently, the losses would need to arise at least in part as a result of something more than a simple error (such as recklessness or deliberate wrongdoing on the part of the firm or individual). While reviewing the arrangements we wanted to re-examine whether there were ways to reduce the risk of clients with claims against closed firms purely on the grounds of negligence being left without a remedy.
14. Though some of the concerns raised during the consultation on this point may have been open to debate, this was the one proposal where the consensus of those responding (including the Legal Services Consumer Panel) was a negative one. We do not intend to pursue this proposal further therefore. Nevertheless we do remain mindful of this issue and of the Consumer Panel's concerns about the growing disparity between the consumer protections afforded to clients depending upon by whom their law firm is regulated. We have therefore separately consulted with insurers to implement a change to the minimum terms of cover which would require insurers to provide run-off even if the firm is in default.
15. We shall set out below in more depth the anticipated effect of the key changes proposed.

The effect of introducing eligibility criteria (rules 6(1) and 6(5))

16. Given the limited resources available, access to the compensation arrangements is already restricted to those most likely to need it. Successful applicants must demonstrate that without a grant being made under the scheme that a person would suffer hardship as a result of the monies lost, while working with a CILEx authorised entity. The intention of the eligibility criteria is to provide greater clarity as to who would definitely not be able to claim on the compensation scheme. We consider that this will enable greater clarity for consumers as well as making the scheme easier to insure on an ongoing basis.
17. The effect of the revised criteria is that the scheme will be more expressly limited to:
 - consumers (i.e. any individual acting in a personal rather than a business capacity which would include an executor for a deceased individual's estate);
 - trusts with a net asset value of £2 million or less; and
 - companies and other undertakings (including unincorporated associations and charities) who have annual income in the last accounting year (including annual turnover after the deduction of tax) of less than £2 million.
18. As well as being broadly in keeping with the approach of the SRA we are also conscious that these sums are more consistent with the limits of the Legal Ombudsman scheme, which excludes businesses with turnover in excess of €2 million. We have sought to provide a relatively simple set of definitions for this purpose.
19. We would stress that as yet there have been no claims on the CILEx Compensation Fund (indeed, no claims are expected for some years given that currently there are 8 authorised entities). This means that there is no claims data available to assess the likely impact of these proposals in an empirical manner. Given the lack of data available we have been more cautious in assessing the concerns raised during the consultation as to the possible impact of this proposal (see our analysis of responses at **annex 4** for more detail). As a result our final proposal represents a substantial increase in the proposed level for the eligibility criteria than had originally been envisaged. The proposed eligibility criteria it is now more in keeping with similar provisions operated by the SRA and to a lesser extent the Legal Ombudsman.
20. Given the requirement to demonstrate hardship within the existing regime and the typical markets in which current CILEx Authorised Entities operate, we consider it unlikely that this change will have a significant material impact. We also consider it right as a matter of principle that only small commercial organisations should benefit from the limited resources committed under the scheme with the primary intention of protecting those who need protection most. Given the

evidence available we feel that the final eligibility criteria proposed strikes the right balance between ensuring a proportionate and sustainable compensation scheme and an appropriate level of protection for those consumers of legal services most in need of protection.

21. To summarise the effect of this proposal it will:

- bring greater clarity that larger organisations will not be able to claim under the compensation scheme;
- be unlikely to have a material impact upon protections afforded to clients given the existing requirement to demonstrate hardship as a result of the loss before a claim can be made;
- further the principle that the limited resources of the scheme should be reserved for those most in need in a manner which is broadly consistent with approaches adopted by other legal services regulatory / complaints bodies; and
- enable the transition to a more effective, proportionate and sustainable compensation scheme.

The effect of introducing an aggregate limit on claims (rule 9(2))

22. The proposal is to place a formal and express limit on the amount of money which can be paid out under the compensation scheme of £2 million for any one firm.

23. The aggregate is not limited in time. The nature of claims on the compensation fund is such that it would be relatively unusual for a firm to have claims made on the fund and for the firm to be continuing in practice. Typically where there has been some form of dishonest misappropriation or failure to account, which has not been covered by professional indemnity insurance (pre-conditions to claim on the fund), then a firm will be intervened into.

24. In terms of assessing the impact of this proposal, again, because there have been no claims yet under the rules, there is no directly relevant dataset available. We have instead considered data available from other regulators as a means of seeking to gauge as far as possible what the likely impact of such a change would be. It is understood that the Council of Licensed Conveyancers (CLC) on average pay out £30,000 to £40,000² per successful claim. It is perhaps worth noting in this context that CILEx Regulation is unlikely to be exposed to the same number of claims per entity as the CLC, given that overall it regulates some lower risk work than purely conveyancing and probate (though it does also authorise firms in those areas). It has been difficult to find data on the total number of claims per firm but based upon the data available as described above and information obtained

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<http://www.legalservicesconsumerpanel.org.uk/ourwork/Financial%20Protection/FPAs%202013%2006%2010%20final.pdf>

anecdotally it appears highly unlikely that an aggregate limit of £2 million would be exceeded.

25. It was for these reasons that the Compensation Fund was initially established with a pledge of £1 million by CILEx. We had initially envisaged that the £1 million committed by CILEx to establish the Compensation Fund would over time be added to and eventually replaced by Compensation Fund contributions paid by CILEx Authorised Entities. However, the number of CILEx Authorised Entities is not yet at a level for which the entity regulation regime was originally designed.
26. Under current arrangements, in the unlikely event that the £1 million insurance and £1 million fund are exhausted by claims, the scheme would be unable to make any payments for the subsequent foreseeable future (i.e. until contributions build). No further funds are available from CILEx for this purpose and the monies available from other entities by way of an emergency call would be limited due to current numbers.
27. On a practical level therefore transitioning to a largely insurance backed compensation scheme would not reduce the protections afforded to consumers. This is because currently the scheme is already limited in practice to £2 million per firm (£1 million being the total of the fund plus insurance with a £1 million per law firm aggregate limit). However, in order to move towards a largely insurance backed compensation scheme we would propose expressly to limit the sum which could be paid in aggregate in respect of one particular firm within the rules (i.e. to £2 million per firm). One of the advantages of transitioning towards an insurance backed compensation scheme would be the ability of an insurance company to meet varying claim levels. We are proposing to insure the compensation arrangements to a total of £6 million per annum with a £2 million maximum aggregate per annum for claims made in respect of one particular law firm. This will represent an increase in the protections available to consumers as compared with the current arrangement whereby a potentially finite fund is maintained.
28. It should perhaps be noted that the contract of insurance (currently in place and to be expanded) covers grants on the fund such that when a grant is made by a CILEx Regulation appointed decision maker the underwriter is required to pay the relevant monies to CILEx Regulation. We do not envisage a scenario in which liability would be avoided, although clearly the compensation rules should be followed in making decisions under the scheme. While for clarity and as a matter of prudence, the rules do propose making payment of a grant subject to the sum being paid by the insurers, we do not anticipate this being an issue in practice given the insurance terms as summarised above.

29. In the course of updating our guidance on compensation scheme claims we have given consideration to possible scenarios which could result in the aggregate provision limiting the sums which can be paid out. In order for the aggregate to become relevant there would have to exist an unlikely scenario in which one CILEx authorised entity has misappropriated funds from a number of different cases (there is an existing £500,000 limit on grants) which exceeded £2 million in total. This possible scenario already exists as a risk for consumers given the existing limits on the fund (i.e. to £2 million) and that money could not be paid out which is not available. However, we would propose guidance to clarify the approach in this respect given the express nature of the new rules on this point. The effect of the new guidance shall be that if it appears that an aggregate limit may be reached:

- urgent grants should be made on an interim basis until the Adjudicators are in a position to estimate the likely total exposure to the fund; and
- where necessary all claims would be settled on a pro rata basis depending upon the proportion of funds available to settle the eligible claims made.

Grants paid out on an urgent interim basis will be subject to a conservative approach, taking account of the risk of depleted sums being available for the remaining claimants. This is because any overpayments could not be recovered unless the claimant is not entitled to some or all of the money they have received.

30. To summarise the effect of this proposal it will:

- have a neutral impact upon the ability of individuals to claim on the fund in respect of one law firm which has misappropriated monies or similar (given the existing constraints on funding and the limited number of contributors to the compensation fund);
- enable the transition to a largely insurance backed scheme which it is proposed will increase the funds available to pay multiple claims in respect of multiple firms to a total of £6 million.

The effect of the changes to the time limits for making grants (rule 7(b))

31. Currently the rules require prompt submission of a claim and set a strict one-year cut off point for clients to make claims under the scheme. We consider that it would be beneficial for decision makers to have an exceptional circumstances discretion to extend the time limit within which a claim may be made. This would be in case unforeseen problems prevent a claim being made earlier e.g. a sustained period of incapacitation through poor health. Otherwise a claimant under the scheme may be denied redress in circumstances in which fairness would suggest that the person should be eligible for a grant.

32. Responses to this proposal during the consultation were broadly supportive. We do not consider this to be a contentious issue and consider that it is a sensible precaution to work in some flexibility around the currently very strict cut off point for claims on the scheme. We have considered the requests made during the consultation period by some for more guidance on this point but would prefer to keep the exception relatively broad. 'Exceptional circumstances' is a reasonably well understood discretion for decision makers to exercise and in our view too much prescription as to intended use could defeat its purpose i.e. to address unforeseen and unusual circumstances.

The effect of other changes to the rules

33. Other changes include:

- stating more clearly that acts or omissions of employees of CILEx Authorised Entities and losses arising from reserved and unreserved work of a type which the firm is authorised to conduct come within the scope of the scheme. This is intended to minimise the risk of a consumer's claim being rejected where a literal interpretation of the rules is applied in a way which is not in keeping with the spirit of the scheme. We do not anticipate a likely impact in practice;
- requiring applicants for grants on the fund to pursue alternative remedies and enquiries in all cases (including from third parties) save where it would be unreasonable to do so. Currently, decision makers would generally be expected to exercise a discretion requiring such steps to be taken. However, it is only a discretion at present. Given the nature of the Fund we consider that it would be more appropriate for the starting point to be that steps be taken to fully investigate alternative remedies. Instead, we consider that discretion should exist to waive this default position where the claim is for an interim grant, or there is no reasonable prospect of successful recovery, or similar good grounds for not doing so before a grant is made. As well as more closely representing the intended policy in this area this change would also assist in moving towards a primarily insurance backed regime. We do not anticipate a likely impact in practice; and
- to incorporate certain aspects of existing policy/guidance into the rules. For example, the new rules would expressly allow for interim payments to be made in urgent cases and also put beyond doubt that grants cannot be made in excess of available funds. Such changes do not however represent a shift in policy or approach and should not result in an impact in practice.

34. A more detailed note of the nature of each change within the rules is set out within the table at **annex 2**. As set out within the table these

other changes do not represent significant changes of substance and are not expected to have a material impact / effect.

D. Rationale for amendment and outcomes sought

35. The most significant changes proposed are intended to facilitate a move to a largely insurance backed compensation scheme, rather than one which is reliant upon the maintenance of a potentially depleting fund. As set out above, the intention had been for the existing £1 million fund to be grown and maintained over time by contributions from CILEx authorised entities. However, as also detailed above, for the foreseeable future the compensation fund would likely be limited to the £1 million committed by CILEx when the scheme was established.
36. We consider that funding an insurance premium on an annual basis is more sustainable, proportionate and cost effective than seeking to build and maintain a very large fund which cannot be utilised for any other purpose. This would free up financial resources to be used by the CILEx Group of companies and prepare the foundations for greater regulatory independence should the government require greater separation of representative and regulatory functions in future. Without these changes we have concerns about the sustainability of the regime in the medium term and its ability to respond to unexpectedly high claim levels in the unlikely event of such a scenario arising.
37. We have consulted publicly upon moving to a largely insurance backed compensation scheme and upon the detail of how the rules would change in order to facilitate this. The responses to our consultation were generally very supportive of the move, with key stakeholders recognising its significant advantages. Having listened and responded to feedback received we also consider that we can make the transition while having a broadly positive impact upon the protections afforded to consumers (as detailed above). The premium will be paid by our entities, supported by CILEx from its reserves in the short term until contributions have built up.
38. We have received confirmation that we can increase the insurance currently in place in respect of the scheme to give effect to our proposals. We have considered carefully the potential risks posed by a scheme being dependant upon insurance on the open market but given our experience to date we do not anticipate difficulty in continuing to secure appropriate cover. Overall we consider that transitioning towards a largely insurance backed regime is the better more sustainable option.
39. As set out within **annex 2**, some less substantial changes are also being made to improve the clarity of the rules and to ensure that they adhere to good practice (in particular, that provisions appear in rules rather than guidance where appropriate).

40. In terms of rationale, reference is also made to the remainder of this application and its annexure more broadly.
41. The achievement of the outcomes sought will not be dependant upon behaviour within the regulated community as might ordinarily be the case with a rule change. The outcomes sought will be relatively self-evident upon completion of the proposed changes as primarily they are intended to position the scheme better for an insurance backed model. We will of course need to continue to monitor actively the availability of cover for the scheme and the cost effectiveness of the premiums as compared with alternatives. Also, as and when claims data is available we propose to review the impact of the scheme in practice. In particular we will be keen to review when claims are successful, when they are not and from whom claims are typically made. We will undertake a review of the operation of the revised compensation arrangements. The timing of this review is dependent on the availability of data, however the review will take place no later than 5 years after the implementation of the changes, including whether the aggregate of £2m per firm has been set at the right level.

E. Statement in respect of the regulatory objectives

42. The impact of these proposals upon the regulatory objectives has been considered in broad terms throughout this application and throughout the consultation documentation. During the development of these proposals particular consideration has been given to balancing the desire for sustainable and proportionate compensation arrangements which also provide a robust level of consumer protection. In turn, this has meant balancing the regulatory objectives of promoting competition in the market and access to justice (by ensuring a sustainable entity based regime for CILEx lawyers and their clients) on the one hand and protecting the interests of consumers on the other.
43. In terms of maintaining competition in the legal services market and promoting access to justice we highlighted in the consultation our view that a sustainable entity based regime provided benefits to consumers through increased competition and diversity in the market place. CILEx membership is uniquely diverse and has the potential to offer competitively priced high-quality legal services.
44. As detailed above we also consider that the revised proposals will actually have a positive impact upon consumer protection. Specifically, we consider that a greater level of protection will be afforded to consumers by an insurance backed scheme than realistically could be provided in the foreseeable future by seeking to grow a compensation fund with low numbers of authorised entities. There are also examples of areas in which protection under the scheme has been clarified in such a manner as to benefit consumers under these proposals, such as in adding an exceptional circumstances criterion on the application of the time limit for claiming. Though an eligibility criteria and an

aggregate limit for claims per firm will be introduced these are likely to have a neutral practical impact upon the protection of consumers for the reasons set out above. To the extent that there is a risk of a negative impact we consider that this is justified by the benefits of the proposals, including the desire to ensure a sustainable entity based regime in the interests of competition in the legal services market.

45. The majority of the other changes listed at **annex 2** do not involve any substantive changes and so will have a neutral impact upon the regulatory objectives.
46. Otherwise we consider that the proposals will have a neutral impact upon the regulatory objectives.

F. Statement in respect of the better regulation principles

47. We consider that the proposals are in keeping with the better regulation principles and that our duty under section 28 of the Legal Services Act 2007 has been fulfilled. Reference is again made to the application and annexure as a whole.
48. We have been mindful in particular of the need to perform regulatory functions in a manner which is proportionate. We consider that a relatively modest annual premium is a much more proportionate means of providing for the funding of claims under the scheme. This will allow more effective use of resources including releasing the £1 million, currently committed to the fund, for the use by the CILEx Group of companies with a view to keeping costs low to CILEx lawyers across the full range of CILEx group activities. This action will benefit the CILEx Group as a whole by these changes.
49. In the context of transparency we have consulted publicly on our proposals. In the context of being targeted we have not sought to re-work the compensation fund rules in their entirety or expand regulatory burdens on the market in any way. We have focused upon the key provisions which we consider necessary to address the areas of concern.

G. Stakeholder engagement

50. During the course of the development of the proposals we engaged directly with a number of key stakeholders on the broad thrust of the proposals including CILEx and the Legal Services Consumer Panel. This was extremely helpful in developing our early thinking. Subsequently we also undertook a public consultation in April 2017 (**annex 3**). At each stage of our stakeholder engagement we have listened carefully and openly to the feedback provided. In a number of areas we have undertaken further work and revised a number of proposals. This can be seen in our consultation analysis document for example (**annex 4**), which we have published on our website.

H. Statement in relation to the impact upon other approved regulators

51. We do not consider that these changes will impact upon areas regulated by other approved regulators.
52. During the consultation the Legal Services Consumer Panel raised a concern that there was inconsistency of approach to consumer protection between the different legal services regulators. We sympathise with the concern and would be open to dialogue on this topic. We have had regard to this issue as our proposals have developed but presently we are not able to progress matters further as regards the wider legal services sector.

I. Timetable for implementation

JULY 2017	Insurance Policy updated to incorporate additional requirements
AUGUST 2017	Implement new rules and guidance
AUGUST 2017	Communicate changes & update website
AUGUST 2017	Close down CILEx Compensation Fund Ltd

J. Contact details

53. The contact details for this application are as follows:

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