

Commission on Banking Standards

Memorandum from the Legal Services Board

Introduction

1. The Legal Services Board is the independent body responsible for overseeing the regulation of lawyers in England and Wales. Our goal is to reform and modernise the legal services market by putting the public and consumer interests at the heart of the system. The Board is independent of Government and of the legal profession. It oversees ten separate bodies, the Approved Regulators, which themselves regulate the circa 120,000 lawyers practising throughout the jurisdiction. The Board also oversees the Office for Legal Complaints, which runs the newly established Legal Ombudsman scheme.
2. Our clear focus is on delivering the eight regulatory objectives, set out in the Legal Services Act 2007 (LSA). These are:
 - protecting and promoting the public interest
 - supporting the constitutional principle of the rule of law
 - improving access to justice
 - protecting and promoting the interests of consumers
 - promoting competition in the provision of services in the legal sector
 - encouraging an independent, strong, diverse and effective legal profession
 - increasing public understanding of citizen's legal rights and duties
 - promoting and maintaining adherence to the professional principles of independence and integrity; proper standards of work; observing the best interests of the client and the duty to the court; and maintaining client confidentiality.
3. The LSB has no locus to take a policy position on the future of standards setting within the banking industry. It offers the comments which followed purely by way of reflection on its own experience of operating for four years in the Legal Services Sector.

Can two levels of regulation work effectively?

4. The Commission has been considering whether it is practicable or desirable for there to be some form of separate ethical supervision of individuals within the banking industry, which would sit apart from formal statutory regulation of banking entities and the formal regulatory supervision of "approved persons".
5. The tradition in the legal services sector has been for regulation to focus only the behaviour of individuals. However a number of changes in the marketplace over the last 10 years, not simply the LSA, have increasingly placed the focus of regulation as much on entities as on individuals. The LSB considers that this dual focus is absolutely the right one. Individuals need to be given every incentive to live up to the high aspirations of their professional calling, whilst the

firms and other entities which employ them need to be held to account for their direct statutory responsibilities and the maintenance of proper systems of control and governance and internally, not least to enable individuals within the firm to meet their own obligations. The “ethical infrastructure” of organisations has to depend on corporate ethos and behaviour led from the Board downwards quite as much as on ethical obligations on individuals and both elements call for proportionate regulatory supervision.

6. In our context, we consider that it would be very difficult indeed for these roles of individual and entity supervision to be divorced, primarily to ensure that there is no scope for an offending individual or firm to attempt to “shift blame” from the entity to the individual level or vice versa and that any investigation of misconduct can be carried on as seamlessly as possible, without artificial bureaucratic boundaries getting in the way.
7. In relation to financial services regulation, where the statutory regulator has controls which bite on companies not only in relation to formal systems as well as also corporate culture and practice, but also on defined individuals within them, the introduction of a separate body with a focus on ethical standards seems potentially to raise even more complex issues of governance, public understanding and “inter-operability” between organisations.
8. The experience of the legal services sector is that, with considerable effort, it is possible to devise “work arounds” which tackle some of these issues. The rest of this memorandum sets out how these work in practice, However, the Commission will need to consider whether introducing a similar level of complexity into financial services regulation would achieve compelling benefits which were otherwise unattainable or whether simpler regulatory architecture could be more effective.

Issues for consideration in a two tier model

9. Should a division of regulatory labour be envisaged despite the very significant issues noted above, the LSB’s experience suggests that a number of requirements would need to be met as a minimum, were it to have any prospect of success. These conditions include:
 - a common set of objectives, ideally with statutory backing, for both sets of regulators – the LSA helpfully gives both the LSB and the bodies which we oversee a common set of regulatory objectives. While there is often room for debate about the precise intent of the objectives and the relative weight to be given to each of them in a given set of circumstances, the commonality of approach nevertheless provides a common language and viewpoint and reduces the scope for conflict;
 - clear differentiation of roles and function – the LSA makes clear that it is not the job of the LSB to duplicate the activity of the bodies which it oversees nor to substitute its judgement for theirs on matters of detailed regulation or intervention in the regulatory management of the behaviour of an individual or firm. However, the Board does have a wide range of

functions, specified below, to ensure that the overall regulatory system operates in the public interest. The fact that both the FCA and the new “ethical body” may bite on the same individuals in financial services places a particular premium on both clarity of role and consistency of approach to decision-making;

- strong oversight backed by powers of intervention (by the senior regulator or perhaps a Parliamentary body) for use when necessary - where a private or self-regulatory body, even with strong, majority independent membership at Board level, exists to provide essentially public functions, it is, in the LSB’s judgement, imperative that a framework of proportionate control exists in order to both protect the independence of those bodies from those they regulate and to incentivise them to perform against best regulatory practice in the same way as statutory regulators. In the case of legal services, it is important that this is done very clearly at arm’s length from both legislature and executive to ensure that there is similar protection from the perception or reality of unjustified political interference in the process, but this may not be the case in every sector.

Functions of oversight regulation in a two tier model

10. To the extent that a banking standards body were a “pure” professional organisation which did not seek to do more than offer a mark of excellence of performance and set aspirational standards of behaviour, rather than to operate any direct approval or exclusionary role in the labour market, then there may be no need for any formal regulatory approval or oversight of its activities. (The Medical Royal Colleges are perhaps an apposite example here). There may be some merit in some form of memorandum of understanding between such a body and the FCA/ Bank of England to facilitate information exchange, but the relationship would essentially be no different to that which the regulators enjoy with other trade and professional bodies.
11. However more formal arrangements may be necessary if the standards body were seen to be exercising some kind of formal or statutory powers. In this case, the LSB’s experience suggest that an oversight role would be needed to ensure that :
 - the standards of behaviour were properly challenging and arrived at through due process;
 - the body had the capacity and capability to ensure that its aspirations were achieved in practice;
 - the overall framework for this division of responsibility remained under constant review and was updated in the light of change in market conditions.
 - the governance and financing framework was such as to secure its independence from those which it regulated.
12. In the legal services market, the LSB carries out these roles in a number of ways. In relation to the maintenance of standards, the Legal Services Act mandates us to review and approve changes to the “regulatory arrangements” of

those bodies which we oversee. Although the majority of proposals put to us can be agreed very rapidly indeed and often do not need require detailed scrutiny, in other cases testing the proposals against the regulatory objectives and the better regulation principles is helpful in securing a more appropriate outcome.

13. On standards of performance, the LSB has developed a model of best regulatory practice in the legal services sector, which focuses on ensuring that the bodies we oversee
 - have codes of conduct based on outcomes rather than very highly elaborated rules
 - identify and assess the risks of their part of the market robustly
 - supervise firms and individuals effectively especially those which present the greatest risk; and
 - have a wide range of strong enforcement tools which they are not afraid to use where necessary.

We are currently completing our first round of assessments of frontline regulators against these requirements. The Commission may wish to consider whether a similar toolkit could be helpful in ensuring that any ethical body was effective in both standard setting and enforcement.

14. In terms of maintaining the overall framework, the Act gives the LSB a variety of powers to recommend to Ministers and Parliament the creation of new regulators (and Licensing Authorities for alternative business structures) and new “reserved activities” (that is, specific legal services, which can only be provided by an authorised person regulated by one of the front-line regulators). Although the processes in all cases are defined at very considerable length and could benefit from simplification, that split of responsibility between regulator and ministers ensures an absence of “regulatory creep” on the part of the former and “regulatory dabbling” on the part of the latter.
15. On the final point, should a banking standards body emerge from a currently existing body, there would be the opportunity to achieve a clear understandable division, by the regulatory responsibility remaining with the current body and its lobbying and representative arm being spun off, with a challenge to find its own place in the marketplace. Because the reverse process happened in the legal services market, the LSA mandated the LSB to draw up “internal governance rules” to protect the independence of frontline regulators.
16. The rules, which are directly mandated by the LSA and have been the subject of extensive consultation by LSB, include provisions for:
 - ensuring that there is a lay majority with appointments made through a Nolan-type process. Some stakeholders have argued that there should also be a guarantee that the Chair is lay. The LSB, at present, has not taken this view, but the rules made clear that there can be no presumption of a professional Chair;

- assurance that the regulator will have the resources necessary to do the job. The Act makes clear that the LSB has to approve the annual practicing certificate fee level set for both individuals and entities. As a discipline, this has worked effectively for three years. This has the effect that the representative arm of the approved regulators cannot withhold funds in a way that prevents the regulator from doing its job, but, equally, ensures that there is a degree of transparency in the regulator's budgetary request to give proper incentives for efficiency. The LSB has been insistent on proper consultation and transparency of regulators' plans to those they regulate to ensure that this discipline is further re-enforced.
- clear separation of all relevant decision-making – effective “chinese walls” within bodies means, not simply that representative arms should take no part whatsoever in decisions on individual cases, but also that key regulatory strategy has to be totally independent of the representative body (although they will be a legitimate and often influential commentator on what is proposed). Additionally, it is also important that the corporate structure of the body does not mean that the regulator's discretion can be limited by, for example, the imposition of human resource management rules or IT requirements which are not fit for its purpose. Arrangements do need to be put in place to deal with the extreme case of major regulator failure, should a regulatory board turn out to be unfit for purpose, but it is clear that the representative body would need to deal with such an issue in the closest collaboration with the LSB.

17. The implementation of the rules was a far from easy process, although considerable progress has now been made. Ongoing compliance is the subject of an annual audit process overseen by the LSB.

18. The Commission may wish to consider the extent to which the types of disciplines may be necessary to protect the independence of and thereby build public confidence in the effectiveness of an industry-led banking standards body, especially if it were to be part of a body with a lobbying role.

Developmental activity

19. Finally, it is worth noting that the LSA gives the LSB the responsibility to assist in the promotion and development of best practice in regulation and in legal education and training. In practice, of course, much of this responsibility is rightly discharged by frontline regulators, but it is helpful for the oversight regulator to have such a power in order to:

- Make connections between practice of the various bodies which it oversees and practice in other sectors to raise standards generally – in the financial services world, for example, there may be lessons to be drawn from bodies such as the Chartered Insurance Institute of a broader relevance;
- Act as a fulcrum for research, both in helping to ensure that there is not a duplication of effort but also in commissioning material that may not be

developed independently. In our case, this work is developed in collaboration with a Strategic Group drawn from both frontline regulators and academic stakeholders;

- Ensure constant challenge to performance through the regulatory effectiveness model described in paragraph 11 above;
- Ensure that a range of routes are possible to enter the professions in a way which maintain standards, but also enhances diversity in line with the regulatory objectives.

20. One example of developmental activity which may be particularly relevant in this area is the Board's recently commissioned work on the measurement of professional ethics. https://research.legalservicesboard.org.uk/wp-content/media/designing_ethics_indicators_for_legal_services_provision_lsb_report_sep_2012.pdf This study, prepared by Professor Richard Moorhead of University College London, begins to develop thinking about ways in which the "ethicality," importantly of *both* individuals and organisations, can be assessed and also tracked over time. While the concepts involved are complex and would need significant further development before being capable of putting directly into operation, the LSB believes that the work is very suggestive and look forward to discussing how it can be taken to the next stage with our own frontline regulators on the basis that it is important to move beyond bland assertions of the importance of professional ethics into something which can be robustly incorporated into regulatory practice.
21. We would commend this work to the Commission, which may wish to consider the extent to which it is directly transferable or whether there would be benefit in exploring a more sector-specific approach for banking services, irrespective of where the organisational responsibility for its development should lie.