



Solicitors
Regulation
Authority

SRA Compensation Arrangements Review

Consultation: The introduction of an eligibility criteria

May 2014

Consultation - who should be eligible to benefit from the SRA' compensation fund. The introduction of an eligibility criteria

Summary of our proposal

1. We have considered if our compensation arrangements should be open to all consumers, or whether we should, for example, mirror the arrangements adopted by the Legal Ombudsman and industry standards adopted by the Financial Conduct Authority in their management of the Financial Services Compensation Scheme who have restricted their protection to individuals and small entities. Given the differential capacities of consumers to protect themselves, we have concluded that we should make the change in order to focus the fund on those who require regulatory support.
2. In this Consultation Paper we propose that the SRA Compensation Fund Rules 2011 are amended to limit eligibility to claim on the Compensation Fund to:
 - individuals;
 - a micro-enterprise – this would be a business with a turnover not exceeding £2 million¹;
 - a charity with annual income less than £2 million; and
 - a trustee of a trust with a net asset value less than £2 million.
3. The chief impact of the misuse and misappropriation of client money is upon those clients whose money has been misused, although such activities can also harm public confidence in the legal market and solicitors. This can crystallise as an actual loss of money, requiring remedy from the Compensation Fund. Putting in place an eligibility criteria is a key step in ensuring that consumers of legal services are protected.
4. Mr Justice Lawrence Collins in the case of *Re Ahmed & Co (a firm) and others* [2006] EWHC 480 (Ch) commented that "...*Applicants do not have a right to compensation which they are entitled to enforce; all they have is a right to seek a favourable exercise of discretion...*".
5. The eligibility criteria will therefore provide a framework for how we will manage claims on the Fund and will inform good practice in the long term. The criteria will underpin our decisions and our process. We are keen to ensure that we get the eligibility criteria right both legally and to ensure that consumers continue to be protected.

¹ The European Recommendation 2003/361/EC of 6 May 2003 categorises a micro enterprise with having a turnover of not more than €2 million. We consider that it is appropriate to covert the reference to £ sterling.

Why does the SRA need to make compensation arrangements?

6. The SRA's Compensation Fund has been in existence for over seventy years providing cover for solicitors' mishandling of client money.
7. The Solicitors Act 1974 (SA 1974) and the Legal Services Act 2007 (LSA 2007) both set out provisions relating to compensation arrangements.
8. The SRA's policy recommendations must therefore be accompanied by an assessment of whether they fall within the provisions of the SA 1974 and are appropriate to satisfy the requirements set out in the LSA 2007. The challenge is to identify and implement compensation arrangements which have regard to our statutory obligations, regulatory objectives, and the principles of better regulation. We will conduct an impact analysis as part of reaching any final decision post consultation.
9. The background to the SRA's review is set out in page 9 of this paper and we have recently published key documents following research into our current arrangements, arrangements which exist in other jurisdictions and an analysis of firms generating claims. The key documents can be found [here](#).

Who should be able to claim on the fund?

10. At present there is no restriction on who can apply for and be paid a grant out of the Fund. Anyone can make an application free of charge. They do not have to be the clients of the closed firm. A claim can be made by an individual consumer, company, charity or other entity and irrespective of the wealth and means of the applicant.
11. The highest claims by value relate to monies which have been misappropriated in a conveyancing transaction or probate matter.
12. An applicant who can show that he or she has suffered loss as a result of failure to account for money is deemed to have suffered hardship if he or she is an individual whose dealings with the defaulting practitioner have been in a personal capacity. If the applicant's dealings with the defaulting practitioner have been in a business capacity then they must provide evidence to show that the body or individual has suffered or is likely to suffer hardship.
13. If the applicant has suffered loss because of the defaulting practitioner's dishonesty there is no 'hardship test' to satisfy.
14. The SRA's Compensation Fund is generally a fund of last resort. The Fund provides a safety net for those affected by authorised individuals or firms who have misappropriated or failed to account for money in the course of practice. The Fund can also make grants in respect of the civil liability of the defaulting practitioner where the authorised individual/firm has failed to take out qualifying insurance.

15. There are clear advantages to clients and consumers in being able to claim from a compensation fund for financial loss arising from misuse or misappropriation of client money. However, entities regulated by the SRA serve a wide range of clients, from individual consumers to large financial institutions and government agencies. These consumers are not all empowered to the same extent in their choice of service provider. Nor do they possess the same amount of knowledge and confidence to engage with a firm to put things right if they are unhappy with an aspect of the service received. Some are more able to protect themselves than others, for example by insuring themselves against such losses, or demanding that solicitors take additional steps to protect client money, for example by holding it in an escrow account. Large commercial service users are better able to protect their interests and make a commercial decision on the use of legal services and the risks involved.
16. This issue is linked to the ethos of the SRA's compensation arrangements. If contributions are an obligation of membership, this lends itself to the idea that as a group, regulated entities may choose to support only those consumers who are most in need (or most 'deserving'), irrespective of their own client base. In contrast, if the Fund is underpinned by notions of mutual benefit, all firms (including those with a predominantly business client base) can expect to see a commercial advantage to their firm from contributing to the Fund, which would make it difficult to exclude certain classes of consumer from the protection regime.

Our research into why the Compensation Fund was established, however, supports the concept that the Fund should predominantly provide for private individuals and small businesses as they had the lowest levels of experience and expertise in dealing with legal services providers out of all claimants. They were also least able to bear a financial loss if a firm could not replenish funds that had been misappropriated.

17. Section 36 (2) of the Solicitors Act 1974 makes provision for rules to be made which set out the circumstances in which grants may and may not be made from the Fund. The SRA must have regard to the differing degrees of experience and expertise of consumers when securing the appropriate degree of protection for them. The information collected (and published on the SRA's website) about the purpose of the SRA's Compensation Fund and the comparative of other jurisdictions highlighted that, in this context, this means that compensation cover should principally be directed toward those consumers who are least able to sustain a financial loss, namely private individuals and small businesses.

Do you agree with the proposal to introduce an eligibility criteria for applicants making a claim on the SRA's Compensation Fund?

18. Given the differential capacities of consumers to protect themselves, the SRA proposes to amend the definition of 'Applicant' in the SRA Handbook Glossary 2011.

Current definition: 'Applicant' means a *person* or *persons* applying for a grant out of the Compensation Fund under Rule 3 of the *SRA Compensation Fund Rules*.

Proposed definition: "For the purposes of applying for a grant out of the Compensation Fund under Rule 3 of the *SRA Compensation Fund Rules* 'Applicant' means:

- individuals;
- a micro-enterprise – a business with a turnover not exceeding £2 million;
- a charity with annual income less than £2 million; and
- a trustee of a trust with a net asset value less than £2 million."

Do you agree with that only those identified in the criteria should be able to claim from the SRA's Compensation Fund?

19. With the evolution of legal services, increased competition amongst providers of services and the changing needs of consumers, we do not consider that it is effective or efficient for the Compensation Fund to be open to all consumers. It is therefore, appropriate for the SRA to restrict protection to individuals and small entities. It is acknowledged that larger and corporate organisations will be affected by proposed criteria. However, based on the fact that the payment from the Compensation Fund is wholly at the discretion of the SRA, the majority of claims made by the larger and commercial organisations tend to be rejected on grounds that the Applicant appears to have other avenues of redress available or has contributed to its loss.
20. In response to this consultation it is important that we consider the views of all impacted by the proposed change. Respondents may therefore want to consider as part of their response:
 - Who has been protected to date?
 - Who else might be covered?
 - Will it be acceptable for some or all clients not to be protected?
 - If not, how should protection for consumers be delivered?
 - Should the scope of claims covered by the fund be extended?
 - Will this impact on the relationship the SRA has with the Legal Ombudsman, particularly if some types of clients can claim on the Fund but have no right of redress to the Ombudsman?

Impact of our proposal

21. We have considered if this proposal is likely to have a disproportionate impact on vulnerable consumers, BME consumers or any other group. At this stage we do not have any serious concerns about the impact of the proposal having a negative effect on the most vulnerable consumers though we do not have quantitative evidence with which to make this analysis. We do believe that corporate institutions are able to protect themselves as they do not suffer from significant information asymmetry when engaging the services of legal service providers. An impact assessment will, however, be completed as a part of the review and we are particularly interested in any views, evidence or analysis that will support that impact assessment.
22. The proposals set out in this consultation paper primarily advance our objective of protecting and promoting the interest of consumers by having in place appropriate compensation arrangements. We consider the proposals are compatible with our strategic objective of ensuring that the relevant markets function well. By clarifying

the definition of 'applicant' in the glossary of our handbook, we will set out the categories of persons eligible to make a claim on the Compensation Fund.

23. In discharging its regulatory responsibilities, the SRA operates within a statutory framework for regulation provided by the SA 1974, the Administration of Justice Act 1985 and the LSA 2007. The statutory framework provides that the SRA must have regard to, and act in a way that is compatible with, our regulatory objectives. These regulatory objectives can only be achieved if we and our regulated community work together in a spirit of mutual trust for the benefit of clients and the ultimate public interest.
24. We have considered this proposal in line with our regulatory objectives and consider that the introduction of an eligibility criteria will ensure that the interests of those consumers who need support through our regulatory arrangements are adequately protected. Consumers of legal services are entitled to expect a good quality service from those providers they instruct, and they should be able to have confidence that if something does go wrong that there is in place a source of financial redress. The aim of the proposal is to provide those consumers needing support with the assurance and confidence that client financial protection arrangements remain in place.
25. Furthermore, it is anticipated that the proposal will promote competition in the provision of legal services in that providers will look to effective and efficient ways of marketing their businesses and holding client money. Firms advising a consumer will be under an obligation to provide information to their client about the regulation of legal services and what protections are available to them.
26. We believe that limiting eligibility to individuals, small enterprises, charities and trusts will ensure the operation of an efficient and effective Compensation Fund. It is anticipated that the proposal will result in reduced operation costs of managing the Compensation Fund and this reduction is likely to be reflected in future contributions firms make. We will also continue to monitor the criteria to ensure that we achieve the right balance.

Timescales and next steps

27. One of the key challenges in exploring alternatives to the Compensation Fund will be identifying how the complementary aspects of the SRA's client protection regime could be provided or supported by alternative means, and whether an alternative would be sufficiently flexible to give the SRA confidence in the efficacy of its arrangements for consumers.
28. The identification of the optimal compensation arrangements for the future provides regulators, the regulated community and other stakeholders with the opportunity to look at what it means to be regulated by the SRA.
 - What are the benefits and obligations of our regulatory regime?
 - What competitive advantages does it bring to those we regulate?

29. Ultimately, this should form part of the SRA's vision of being the leading regulator of legal services, recognised for the outcomes we achieve in the public interest and the way in which we achieve them.
30. This consultation paper therefore forms part of the first phase of changes to the SRA's compensation arrangements.
31. We welcome comments in respect to all or some of the issues discussed. We also welcome suggestions of other issues which need to be considered in order to develop an authoritative set of policy recommendations for consultation with stakeholders, leading to the identification of a compensation regime which:
 - provides appropriate protection for consumers of legal services;
 - is in accordance with regulatory principles;
 - meets the SRA's regulatory objectives; and
 - stands the test of time.

Consultation questions

- Do you agree with the proposal to introduce an eligibility criteria for applicants making a claim on the SRA's Compensation Fund?
- Do you agree with that only individuals, small enterprises, charities and trusts should be able to claim from the SRA's Compensation Fund?
- If you do not agree with the proposal, please offer any alternative suggestions for reducing the burden on the SRA's Compensation Fund.
- Do you have any views about our assessment of the impact of these changes; and, are there any impacts, available data or evidence that we should consider in finalising our impact assessment?

How to respond to this consultation

Online

Use our online consultation questionnaire {insert link} to compose and submit your response. (You can save a partial response online and complete it later.)

Email

Please send your response to consultation@sra.org.uk You can download and attach a Consultation questionnaire [insert link].

Please ensure that

- you add the title "Compensation Fund - Eligibility criteria" in the subject field,

- you identify yourself and state on whose behalf you are responding (unless you are responding anonymously),
- you attach a completed About You form,
- you state clearly if you wish us to treat any part or aspect of your response as confidential.

If it is not possible to email your response, hard-copy responses may be sent instead to

Solicitors Regulation Authority
Policy and Strategy Unit - Compensation Arrangements Review
The Cube
199 Wharfside Street,
Birmingham,
B1 1RN

Deadline

Please send your response by (6 weeks from publication (proposed date for publication is 6 May 2014)).

Confidentiality

A list of respondents and their responses may be published by the SRA after the closing date. Please express clearly if you do not wish your name and/or response to be published. Though we may not publish all individual responses, it is SRA policy to comply with all Freedom of Information requests.

SRA Compensation Arrangements Review - Background

The SRA is reviewing the arrangements it has in place to compensate consumers of legal services when they suffer financial loss due to dishonesty, failure to account or civil liability of uninsured practitioners

The purpose of the SRA's Compensation Arrangements Review (CAR) is to identify potentially innovative ways of delivering the optimum level of client protection, whether or not that includes compensation arrangements in the form that they currently exist.

Currently, public financial protection in respect of solicitors in private practice is afforded through a combination of four arrangements: compulsory professional indemnity insurance; the Compensation Fund; the intervention process (which includes Statutory Trust Account distribution) and awards made by the Legal Ombudsman. Together these provide comprehensive and wide reaching protection that compares very favourably with the protection and compensation offered by other professions and in other jurisdictions.

Indemnity insurance provides compulsory minimum cover for any one claim of £2 million (or £3 million for recognised and licensed bodies) for all civil liability arising from private legal practice written on Minimum Terms and Conditions of professional indemnity insurance for solicitors and registered European lawyers in England and Wales ("MTC"). The breadth of cover, and the inability of insurers to avoid cover, is unparalleled in the commercial professional indemnity insurance market. The Compensation Fund may provide grants of up to £2 million to replace money which has either been stolen by a solicitor, or to alleviate loss and hardship suffered by applicants where the solicitor has failed to account for money in their possession. The Statutory Trust Account process allows for the return to their beneficial owners of funds held by the SRA after intervention.

The Compensation Fund is a discretionary scheme maintained under the Solicitors Act 1974, from which a grant may be made to an applicant who has suffered a loss due to a solicitor's dishonesty or to an applicant who has suffered loss and hardship due to a solicitor's failure to account for monies held. The Fund is maintained by the Law Society through contributions from practising solicitors. It is subject to its own rules and to public law principles. The current Compensation Fund Rules are set out [here](#).

We are considering the current arrangements and how to ensure that they are consistent with better regulation principles, not only as a means of protecting the consumers of legal services, but also from the perspective of the broader public interest. The public interest can only be protected by ensuring that legal services are delivered ethically and the public have confidence in the legal system and in the quality and effectiveness of legal services. Through its compensation arrangements, the SRA needs to ensure that the public are protected from harm, including that caused by dishonesty, incompetence or unethical behaviour. But we also recognise that consumer protection is not free and it is a cost borne by consumers themselves. If the costs of protection are disproportionate then it can be a contribution towards the lack of affordability and accessibility that typically excludes some consumers from the market. Similarly the SRA recognises that consumers can themselves be a

powerful driver of ethical standards and good service. If incentives for consumers to make good choices are properly aligned with regulation then the overall costs can be minimised.

The LSA 2007 imposes two key obligations on the SRA which will guide our review. Firstly we must undertake our statutory duties in a manner that secures the regulatory objectives. Secondly, in so doing, the SRA must have regard to the principles of better regulation, i.e. our activities should be: transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed. This approach focuses on the outcomes for the public and consumers that result from the activities of those we regulate.

The SRA defines desired regulatory outcomes by identifying what we expect to observe when the market operates in line with the intent of the regulatory objectives. This process provides us with a practical articulation of the characteristics or results that we should be seeking to achieve through our regulation.

Our approach to regulation is enabling and encouraging innovation, regulation of a broader range of business structures, and new approaches to the provision of legal services, as well as providing greater freedom to those we already regulate.

It is clear that the primary function of the Compensation Fund is to make payments to those who have suffered loss as a result of fraud or dishonesty or by a failure to account for client money and provides client account funds for intervention agents to use immediately on an intervention where there are insufficient funds in a client account to protect clients' interests.

As part of the review we have published key documents following our research into current arrangements ([key documents](#)) and data on claims received.

In addition to the key documents, it is noteworthy that the Compensation Fund accounts for the first five months of the 2012/13 practising year showed a balance of £67.1m and the grants to be paid in 2012/13, was estimated to be in the region of £25.1m.

The SRA in its quarterly reports also includes reference to activities relating to the Compensation Fund. In 2013, for instance, 1,233 claims were made to the Compensation Fund, for a total value of £29.35m. The majority of claims related to general client money (misappropriation/failure to account), claims relating to stamp duty land tax, probate and mortgage fraud. The average claim amount for quarter four of 2013 was £32,707 and there were 716 applications under consideration and the pending value of open claims was £45m. Payments on claims closed in 2013 amounted to £20.44m. In 2013, there was a decrease in the percentage paid out on claims closed. This was primarily due to a concerted effort to close Mortgage Fraud claims towards the end of the year. Mortgage Fraud claims generally have high claim values and low percentage payouts.

The review of compensation arrangements is a significant part of the transformation from a rules-based system of regulation led by a professional body, to a modern risk-based system led by an independent regulator, which meets the principles of better regulation. With this we aim to provide more information about the Fund and its operation as a means of protection for consumers.

The review is ongoing but in this consultation paper we set out an initial and immediate step that we consider can be taken safely to improve the balance between consumer protection and cost. In addition to the recently published information pack, we will continue to gather further information to inform our views and will consult on further proposals in due course.

DRAFT