

**EXPLANATORY MEMORANDUM TO
THE LEGAL SERVICES ACT 2007 (LICENSING AUTHORITIES) (MAXIMUM
PENALTY) RULES 2011**

2011 No. 1659

1. This explanatory memorandum has been prepared by the Legal Services Board (“the LSB”) and is laid before Parliament by Command of Her Majesty.
2. **Purpose of the instrument**
 - 2.1 The instrument prescribes the maximum financial penalty which may be imposed on a licensed body, or a manager or employee of a licensed body, by a licensing authority in accordance with its licensing rules. For acts or omissions that are found to be in breach of the applicable licensing rules, the maximum penalty that can be imposed is:
 - £250 million on a licensed body; and
 - £50 million on a manager or employee of a licensed body.
3. **Matters of special interest to the Joint Committee on Statutory Instruments**
 - 3.1 None.
4. **Legislative Context**
 - 4.1 The Legal Services Act 2007 (“the 2007 Act”) sets out a framework for the regulation of legal services in England and Wales. The 2007 Act establishes the Legal Services Board (“the LSB”) as the regulator with responsibility for this new framework. It requires that certain legal services (“reserved legal activities”) may only be carried out by those who are authorised to do so or exempt. It also makes provision for the regulation by approved regulators of those providing such services. A list of approved regulators is set out in Part 1 of Schedule 4 to the 2007 Act¹ and in the Legal Services Act 2007 (Approved Regulators) Order 2011 (S.I. 2011/1118). Section 1 of the 2007 Act sets out regulatory objectives to which the LSB and the approved regulators must have regard.
 - 4.2 Part 5 of the 2007 Act sets out the arrangements under which firms (“licensed bodies”) which are partly or wholly owned or controlled by non-lawyers may provide legal services (or a mixture of legal and non-legal services). Part 1 of Schedule 10 to the 2007 Act allows the Lord Chancellor, on the recommendation of the LSB, to designate approved regulators as licensing authorities for the purpose of Part 5. These licensing authorities may, in accordance with Part 5 and with their licensing rules, grant licences to firms applying to become licensed bodies. A licensed body must comply with the

¹ The approved regulators are listed in the table in paragraph 1 of Schedule 4 to the Legal Services Act 2007 as amended by the Legal Services Act 2007 (Approved Regulators) Order 2009 (SI 2009 No. 3233).

regulatory arrangements set out in the licensing rules of the authority by which it is licensed.

4.3 Section 95 (1) of the 2007 Act allows a licensing authority to impose financial penalties on a licensed body, or a manager or employee of a licensed body, if they are found to be in breach of licensing rules.

4.4 The LSB is required by section 95(3) of the 2007 Act to make rules prescribing the maximum financial penalty that a licensing authority can impose. These rules can only be made with the consent of the Lord Chancellor. This is the first time that these powers have been used.

5. Territorial Extent and Application

5.1 This instrument applies to England and Wales.

6. European Convention on Human Rights

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

7. Policy background

- What is being done and why

7.1 The instrument sets the maximum financial penalty that can be imposed by a licensing authority on a licensed body or on an individual who is an employee or manager of a licensed body. The amount chosen reflects the policy of setting a maximum penalty high enough to provide an effective deterrent against non-compliance with licensing rules. The instrument is one of several measures that will ensure a robust regulatory regime is in place to protect consumers. Having robust regulatory systems and appropriate penalties in place will reinforce the LSB's regulatory objectives of protecting and promoting the public interest and protecting consumers.

7.2 In setting the maximum financial penalty applicable to licensed bodies and individuals, the LSB has considered the size of the legal services market and the range of powers available to existing approved regulators, as well as the powers available to regulatory bodies in other industries, such as the Financial Services Authority ("the FSA").

7.3 In the financial services sector, unlimited maximum fines are available to act as a deterrent. The FSA has a number of powers which allow it to impose a penalty of such amount as it considers appropriate. This power is limited by the FSA's current enforcement policy, which in many circumstances sets the maximum penalty at 20% of a firm's income. The powers of approved regulators to impose financial penalties vary widely but the Solicitors' Disciplinary Tribunal ("the SDT") has the power to impose an unlimited financial penalty on individual solicitors and solicitors' firms. Although it is not possible to provide for an unlimited penalty for licensed bodies, the LSB

considers that setting a very high maximum is likely to have a similar effect in terms of deterring non-compliance with licensing rules. It considers that it is desirable to achieve, so far as possible, a similar approach to the imposition of penalties on licensed bodies as exists in relation to solicitors (which constitute a significant proportion of the legal services market).

7.4 Taking all of these factors and the responses to the consultation into account, the LSB has concluded that the maximum financial penalty should be £250 million for a licensed body and £50 million for an individual who is a manager or employee of a licensed body (including a person who was previously a manager or employee of the licensed body at the time of the breach for which the penalty is being imposed).

7.5 Although the proposed maximum amounts are high, there are safeguards in place to ensure that licensing authorities impose a proportionate penalty in each case. For example, the LSB's guidance provides that licensing rules should set out the criteria and procedure to be applied when determining whether to impose a penalty and the amount of any penalty. The LSB also expects licensing rules to provide for any penalty imposed to be proportionate to the nature of the breach. There is also an appeal mechanism under section 96 of the 2007 Act whereby licensed bodies and individuals may appeal against a financial penalty on the grounds that its imposition, its amount or the time within which it must be paid, is unreasonable.

- Consolidation

7.6 There are no earlier statutory instruments which deal with the same subject matter and therefore consolidation is not an issue.

8. Consultation outcome

8.1 The LSB has carried out two consultations on the maximum financial penalty rules. It published a consultation document on 18 November 2009. This consultation set out several proposals for the regulation of licensed bodies, including the proposal that there should be an unlimited penalty for licensed bodies and for individual managers and employees. The consultation ran for over 12 weeks. A draft of the proposed statutory instrument was annexed to the consultation document.

8.2 The consultation received 46 responses from a diverse range of respondents including small firms. Several respondents agreed with the LSB's proposal that there should be an unlimited financial penalty for a licensed body or individual that had breached the licensing rules. Those that disagreed with the proposal for an unlimited fine did so for a variety of reasons, including concerns that allowing penalties up to an unlimited amount would actually act against transparency and fairness in decision-making. However, the LSB considered that giving licensing authorities the ability to levy an unlimited financial penalty was vital to ensuring compliance with licensing rules, thus ensuring adequate consumer protection. The consultation responses relating to this instrument are available on www.legalservicesboard.org.uk.

- 8.3 On 23 December 2010 (following further consideration of the power under which the Rules were to be made) the LSB published a further consultation that set out alternative approaches to prescribing a maximum amount. It proposed that the maximum financial penalty should be set at £150 million for entities and £50 million for individuals. A draft statutory instrument was included. The consultation closed on 24 January 2011. A shortened consultation period was appropriate because the LSB had already consulted on the substantive issues concerning enforcement against alternative business structures.
- 8.4 The second consultation received five responses. No small firms responded to it. All respondents agreed with the proposal to set a fixed amount as the maximum, rather than specifying a formula by which it could be calculated in individual cases. ILEX Professional Standards (“IPS”) thought that the proposed amount for individuals was very high. However, the Solicitors Regulation Authority (“the SRA”) was concerned that the proposed maximum penalty for entities was too low to deal with significant misconduct. It gave the example of some solicitors’ firms which made profits of over £120 million from miners’ compensation claims for chronic obstructive pulmonary disease, many of whom were the subject of proceedings before the SDT. The SRA’s concern was that if a similar scale event occurred again it may involve a smaller number of firms, resulting in profits that were above the proposed £150 million maximum. The SRA’s view was given particular weight as it is one of two approved regulators that have applied to become a licensing authority (the other being the Council for Licensed Conveyancers). Furthermore, as the regulatory arm of the Law Society, the SRA regulates a substantial proportion of the legal profession. The LSB was not persuaded by IPS’s view, considering that a high maximum penalty for individuals would give licensing authorities flexibility to choose the appropriate penalty in each case, and that it would act as a strong incentive to comply with the regulatory framework.
- 8.5 Following careful consideration of all the consultation feedback and taking into account the need to ensure robust safeguards are in place to protect consumer interests and the reputation of the legal profession, the LSB decided to amend the draft rules to increase the proposed maximum penalty for entities from £150 million to £250 million. The LSB considered that this was a material change to the draft statutory instrument included in the consultation (albeit not a change to the underlying policy intention). Therefore, in accordance with section 205(5) of the 2007 Act, it published the details of the differences between the proposal at consultation stage and the LSB’s final decision. The proposed maximum penalty for individuals remains unchanged following the consultation.

9. Guidance

- 9.1 The Board has issued guidance to licensing authorities on the content of licensing rules and has published this guidance on its website.²
- 9.2 Under this guidance, licensing rules are required to set out the criteria the licensing authority will apply in deciding whether to impose a penalty and the factors that will be taken into consideration when deciding the appropriate level of any penalty. The guidance also states that it is important that licensing authorities retain maximum flexibility to decide whether to impose a penalty on an individual or an entity or both, and the amount of the penalty. Because of this, the LSB does not consider that licensing authorities need to set out indicative penalties in their licensing rules, as this may lead to firms attempting to calculate the likely price of non-compliance and deciding to take the risk of a small fine rather than complying with the rules.

10. Impact

- 10.1 These Rules do not impact on business, charities or voluntary bodies unless they choose to become a licensed body. The provisions of this instrument will only impact on licensable bodies or their managers or employees in the event of a licence breach by those bodies or individuals. It may also have an impact on how licensed bodies manage risk.
- 10.2 Section 97 (3) of the 2007 Act requires a licensing authority to pay any sum received under section 95 of the 2007 Act to the Consolidated Fund. A licensing authority cannot therefore benefit financially from the imposition of a penalty.
- 10.3 There is no impact on the public sector unless the organisation (or part of it) chooses to become an ABS.
- 10.4 The final Impact Assessment is attached to this memorandum and will be published alongside the Explanatory Memorandum on www.legislation.gov.uk

11. Regulating small business

- 11.1 The legislation applies to small businesses.
- 11.2 To minimise the impact of the requirements on firms employing up to 20 people, licensing authorities must have regard to the principles of better regulation and best regulatory practice when deciding the amount of any penalty (section 28 of the 2007 Act). The penalty must therefore be proportionate to the transgression as decided on a case-by-case basis. The provisions in the 2007 Act do not give any body the power to exempt small businesses from liability to pay a financial penalty if they breach their

²http://www.legalservicesboard.org.uk/what_we_do/consultations/closed/pdf/abs_guidance_on_licensing_rules_guidance.pdf

licensing rules although licensing authorities have discretion as to the size and way in which the penalty is levied.

- 11.3 The basis for the final decision on what action to take to assist small business is not relevant to this instrument.

12. Monitoring & review

- 12.1 The LSB will review the maximum penalty in light of licensing authorities' experience of using financial penalties as an enforcement tool. The policy will be judged to be successful if there are no reported incidents where a licensing authority considered that the maximum penalty was too low for it to impose an appropriate penalty. A review will be carried out no later than three years after implementation but earlier if necessary.

13. Contact

Christopher Baas at the Legal Services Board (Tel: 020 7271 0055 or Email: christopher.baas@legalservicesboard.org.uk) can answer any queries regarding this instrument.