

Agenda

Advancing economics in business

Regulatory reform: changes and consequences in the legal services sector

The regulation of legal services in the UK and the rest of Europe is currently under review. We discuss some of the changes introduced in the Legal Services Act 2007, and draw on research recently conducted for the Legal Services Board into how to monitor the effect of regulation on the market

In the UK, new legislation is being implemented to create a framework for the independent regulation of legal services while liberalising the market to allow 'alternative business structures' (ABSs). The beginnings of these reforms date back to the 2001 Office of Fair Trading (OFT) investigation into competition for professional services.¹ In each sector investigated (accountancy, architecture and legal services), the OFT identified a number of rules imposed by the relevant trade associations and professional bodies that restricted competition and might not be justified in terms of consumer protection. For example, in the case of legal services, the OFT was concerned about rules imposed by the Law Society and/or Bar Council that restricted the types of legal business structure, advertising techniques and the ability of customers to instruct barristers directly.

In this context, the Ministry of Justice appointed Sir David Clementi to carry out a further, independent review of the regulation of legal services in England and Wales.² Sir David's recommendations form the basis of the Legal Services Act 2007, which substantially reforms the regulation of legal services (see the box below).

The Legal Services Act 2007 applies to the provision of legal services in England and Wales only. The regulation of legal services in Northern Ireland is also undergoing reviews,³ and in Scotland, a comparable Act to the Legal Services Act 2007 was passed into law in October 2010.⁴ While there are differences between the Acts, both propose measures to liberalise the provision of legal services, and to promote competition and the interest of consumers.

Overview of the regulation of legal services in England and Wales

The Legal Services Act 2007 substantially reshaped regulation for legal services in England and Wales. It provides the framework for independent regulation and allows ABSs to become regulated as law firms.

The Act:

- establishes a single supervisory body, the Legal Services Board (LSB), to oversee the approved (frontline) regulators;
- separates regulation from professional representation;
- defines common statutory objectives and duties for all regulatory bodies;
- creates ABSs by allowing lawyers to form partnerships with non-lawyers, and accept outside investment or operate under external ownership;
- establishes a single, independent consumer complaints body, the Office for Legal Complaints;
- defines six reserved legal activities: the exercise of the right of audience; conduct of litigation; conveyancing; probate; notarial activities; and administration of oaths;

- sets out the framework for extending the list of reserved activities.

Scope of regulation

To provide any of the six reserved legal activities on a commercial basis in England and Wales, authorisation from an approved regulator is required. In addition, once authorised, all other commercial activities undertaken by such practitioners, reserved or otherwise, also fall within the scope of regulation.

The list of reserved activities can be considered limited in scope compared with what is often commonly understood by legal services. This means that some 'legal' services can be provided without formal authorisation from legal service regulators. For example, advice on transactional matters, such as will writing and employment contracts, can be provided by unauthorised persons, as can initial, non-litigious advice in personal injury cases.

This article draws on Oxera (2011), 'A Framework to Monitor the Legal Services Sector', prepared for the Legal Services Board, September, available at www.oxera.com.

Concurrent with these UK initiatives, the regulation of legal and other professional services has also been under review in other EU Member States. In some countries, such reviews were motivated by European Commission recommendations dating back to 2004, which advised national regulatory authorities to consider whether existing trade association rules were necessary, proportionate and justified.⁵ In other countries, legal regulatory reform has been initiated by more recent international pressure. In the case of Ireland, for example, regulatory reforms to the legal services sector form part of the conditions of its bail-out agreement with the EU, International Monetary Fund and European Central Bank.⁶ The Legal Services Regulation Bill 2011, presented to the Irish Parliament in September 2011, proposes reforms to relax restrictions on business structures, to establish a new regulatory authority and disciplinary tribunal, and to change the assessment and charging of legal costs.

Alternative business structures

Across Europe, Member States have restricted the types of business structure that can provide legal services. Typically, such restrictions were introduced to protect consumers and the integrity of the profession, but in the 2004 European Commission investigation these restrictions were identified as potentially having negative economic consequences.

More recently, many Member States have begun to review, and in some cases relax, restrictions on business structures. For example, in addition to Scotland, England and Wales, Germany, France, Spain, Denmark, Switzerland, the Netherlands and Ireland all allow forms of non-lawyer involvement in the management of law firms.

Reforming the restrictions on business structures could have a substantial impact on the suppliers of legal services, which in turn could have important implications for the legal services sector more broadly. In England and Wales, prior to the Legal Services Act, unless providing legal services only to their employer, solicitors could practise only as sole traders or in partnerships with other solicitors, while barristers were prohibited from joining any form of partnership and could practise only as sole traders or as employees providing legal services in house.

The Legal Services Act changes this. Once fully implemented (which is expected by the end of 2011), only the Head of Legal Practice must be an authorised (ie, regulated) legal professional.⁷ All other positions, including other managers and owners of the business, do not have to be lawyers.

These changes provide firms with much greater flexibility to develop business structures that deliver

efficient, cost-effective legal services. For example, existing law firms can choose to join forces with other professional businesses such as accountants, estate agents or banks to provide a more comprehensive service offering to customers. Firms competing in other sectors can also choose to hire lawyers as employees and offer legal services to the market.

The introduction of ABSs also provides greater flexibility in how law firms can raise finance and reward employees. For example, law firms can now access capital markets or raise finance by creating networks and sharing investment costs in overheads such as IT. Law firms can now also reward in-house barristers and internal business management staff in the same way as solicitors, through ownership and/or management positions. By reducing the barriers to entry, the introduction of ABSs can be expected to increase competition in the provision of legal services and drive further innovation and cost savings in their delivery.

The introduction of ABSs has also raised some concerns, however. In particular, it has been suggested that, due to competitive pressures from these new structures, the number of small 'high-street' law firms will fall, with the risk that access to justice will deteriorate as customers have to travel further to obtain face-to-face legal advice.⁸

While competitive pressures from ABSs may pose a risk to the financial viability of high-street law firms, as these firms are currently set up, it is less clear whether there would be any further negative effects for consumers. In particular, there has been a debate about whether a reduction in the number of traditional high-street law firms could reduce access to justice. For example, legal advice does not always have to be delivered face-to-face; consumer research undertaken by the Solicitors Regulation Authority found that participants were prepared to compromise more on locality of provider than on expertise or price, and that 'ease of getting in touch' (eg, response to emails or phone calls) was as valued as geographical proximity.⁹ In addition, ABSs may themselves deliver local face-to-face advice. At the same time, justice does not necessarily need to be delivered through the courts or require the assistance of authorised persons. For example, the UK Ministry of Justice is currently pursuing policies to encourage arbitration and alternative resolution mechanisms to help to control civil legal costs.¹⁰

Indeed, should the introduction of ABSs be effective in increasing competitive pressures, this could enhance access to justice, with cost savings and efficiencies being passed on to customers in the form of lower prices and improved product offerings. As a final safeguard, the Legal Services Act requires that any

licensing authority ‘when considering the regulatory objectives...in connection with an application for a licence, should take account of the objective of improving access to justice’.¹¹

Monitoring the impact of regulation

In the context of such substantial regulatory reform, the LSB commissioned Oxera to develop a framework that could monitor change in the sector, to help to assess the impact of regulation and inform future regulatory interventions. Such a framework involves two parts: segmenting the market, and defining the indicators.

Market segmentation

The legal services sector in England and Wales is diverse, employing around 137,000 authorised persons to provide a broad range of services to a spectrum of consumers, under different regulatory rules.¹²

Therefore, the full impact of many regulatory reforms is likely to be complex, with different implications in different legal services markets. The demand for legal advice is also very specific—in general, advice in relation to, say, conveyancing is never a substitute for advice on, say, personal injury compensation.

Competition policy tools such as the hypothetical monopoly test, which is used to define ‘relevant markets’ (and involves assessing demand- and supply-side substitution), provide a conceptual basis for this market segmentation. Such tools are most commonly used to define relevant markets for the assessment of specific competition problems, which is often a complex exercise. Such an exercise would result in precisely delineated markets, which would not be practical for data collection in this framework. Therefore, while high-level markets should be primarily identified from the perspective of demand- and supply-side substitution (following common practice in competition policy), they should generally be less refined than they would be if provided in a formal market definition exercise. Instead, the focus should be on identifying why individual markets might function similarly or differently with respect to changes in regulation. For markets that are likely to behave in a similar manner, information can be combined, but where markets are likely to behave differently, the information collected should, ideally, capture this level of detail.

In this context, the following three characteristics form the basis of data collection market segmentation.

- **Type of consumer**—this can affect the supplier–consumer relationship and the types of legal service required. Relevant questions to consider include the following.
 - Is the consumer a natural person, or a legal person/government body?
 - Does the legal person have an in-house legal team?
 - Does the government have market power in this area of law—eg, being the only consumer?
 - Is the natural person benefiting from legal aid?
- **Type of consumer problem**—there are a multitude of problems on which legal advice might be sought and, since consumers cannot alter the nature of these problems, there is limited substitutability on the demand side. However, for some areas of law there is sufficient supply-side substitution such that data can be collected at an aggregate level without significant loss of detail. For example, 90–95% of solicitor firms offering advice on banking law, computer and IT law, corporate finance and mergers and acquisitions also offer advice in the general field of business affairs.¹³
- **Type of legal service activity**—this can limit the extent of the possible supply-side substitution (ie, the extent to which suppliers can supply different legal services). For example, the market for basic advice in injury cases may function differently to the market for litigation, due to the regulatory barrier controlling the provision of litigious services.

These three dimensions can be considered together to give a breakdown of the legal services sector. However, in some cases, focusing on only one or two dimensions may be appropriate. For example, when collecting information on the conduct of supply from legal services suppliers, certain indicators may be set at the level of the firm, and therefore be constant across all areas of law and types of customer. Such indicators would include legal registration status and the number of overseas affiliations.

Indicator definition

Markets can differ in a multitude of ways, not all of which would be relevant to a regulator. The eight regulatory objectives defined in the Legal Services Act, set out below, help to identify the characteristics and outcomes of the market that are important to the LSB, and therefore important for it to monitor:¹⁴

1. protecting and promoting the public interest;
2. supporting the constitutional principle of the rule of law;
3. improving access to justice;
4. protecting and promoting the interests of consumers;
5. promoting competition;
6. encouraging an independent, strong, diverse and effective legal profession;
7. increasing public understanding of the citizen’s legal rights and duties;

8. promoting and maintaining adherence to professional principles.¹⁵

Some of these objectives go beyond ‘traditional’ market outcomes from an economic perspective, and can be considered intermediate outcomes that would contribute to improving final market outcomes for consumers—as is clear from objective 6, for example.

To assess the effectiveness of regulation in achieving progress along each regulatory objective, it is often necessary to monitor multiple indicators, for two reasons:

- because there may not be one single indicator that fully captures the regulatory objective. For example, improving access to justice can be considered to consist of a number of features, including improving the affordability, quality and availability of legal advice. In turn, multiple measures will help to inform progress on each of these features. For example, the affordability of legal advice includes the price paid to the legal professional as well as any other costs involved in seeking such advice;
- to isolate the impact of regulation from other factors also driving changes in the market place. For example, it is often necessary to monitor indicators that capture other drivers of change (eg, public policy changes), and intermediate indicators that link the regulatory change to the observed changes in final market outcomes.

Therefore, when benchmarking legal services, it can be useful to monitor indicators in the following areas.

- **Drivers**—these indicators monitor the emergence of developments, shocks or trends that are likely to drive changes in the legal services sector. Indicators are generally binary: does a regulatory change occur? Has the Ministry of Justice altered the funding of legal aid? They form the first part of a chain of events that may alter outcomes for the consumer.
- **Market functioning**—these indicators help to understand the mechanisms and processes through

which the drivers may alter the composition of supply and/or market outcomes. They consider why the market is not functioning effectively—for example, are there barriers to entry? Can consumers effectively choose between providers? Can consumers complain effectively? By identifying the market dynamics, the mechanisms through which regulatory changes (and other drivers) affect the sector (or parts of the sector) can be assessed.

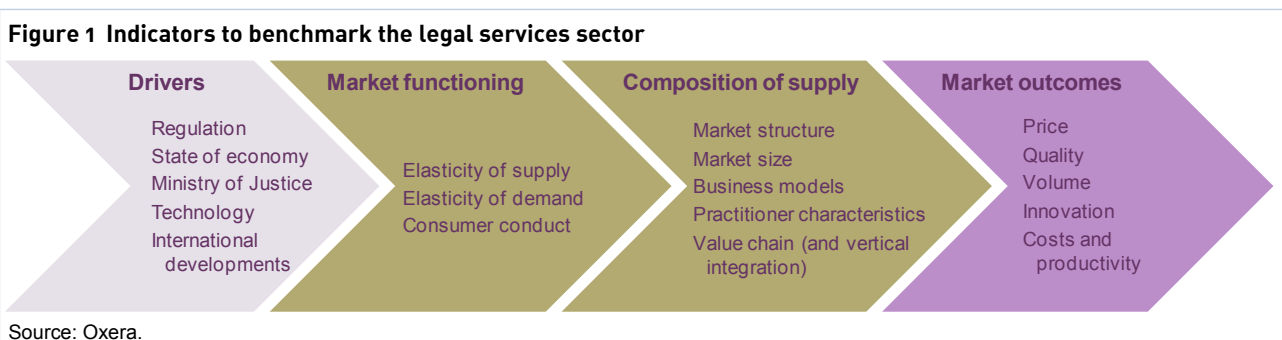
- **Composition of supply**—similarly to the market functioning indicators, these indicators are relevant to understanding how drivers may alter market outcomes. They provide information on the conduct of supply, and can therefore be useful in providing early evidence of supply-targeted regulation—for example, has allowing ABSs resulted in additional business registrations? Have market shares changed? Are these new businesses behaving differently to the way in which incumbents behave? In this way, such indicators can be important in establishing the causality of changes in market outcomes.
- **Market outcomes**—these indicators monitor the performance of markets. Relevant indicators consider what matters to consumers—ie, price, quality and access (as part of volume)—and evidence on the efficiency of the market more generally—ie, innovation, costs and productivity. According to the immediate regulatory focus, the relative importance of different indicators may differ.

The broader topics in each of these areas are summarised in Figure 1 below.

Next steps

Implementation of the Legal Services Act 2007 is already in progress, and many of the reforms are expected to have far-reaching consequences. In some cases, the potential for adverse effects has been identified, for example in the introduction of ABSs, and it would be useful to monitor this.

Disentangling the impact of regulation is not without its challenges. Regulatory reform is not the only factor



influencing the legal services sector. Public policy changes—such as changes to the funding of legal aid¹⁶ and reforms to conditional fee arrangements;¹⁷ the economic recession and housing market stagnation; and technology advances and the growth of the Internet—are just a few of the other factors identified.¹⁸

Despite these additional influences, the realised impact can be monitored by establishing a conceptual framework that identifies the mechanism through which each regulatory change is *expected* to affect the

market (positively or negatively). By identifying this, the conceptual framework helps to identify both the types of change and their chronological order, should the reform be having its intended (or unintended) effect(s). These predicted changes form the basis of the indicators which, if monitored, should enable the impact of the regulatory change on the market to be observed. Guidance on relevant indicators, metrics, data collection techniques and the appropriate level of market segmentation is provided in the methodology report prepared by Oxera for the LSB.

¹ Office of Fair Trading (2001), 'Competition in Professions', OFT328, March.

² Clementi, D. (2004), 'Report of the Review of the Regulatory Framework for Legal Services in England and Wales', prepared for the Ministry of Justice, December.

³ See, for example, Legal Services Review Group (2006), 'Legal Services in Northern Ireland: Complaints, Regulation, Competition'.

⁴ HM Government (2010), 'Legal Services (Scotland) Act 2010'.

⁵ European Commission (2004), 'Report on Competition in Professional Services', February.

⁶ European Commission (2010), 'Ireland Memorandum of Understanding on Specific Economic Policy Conditionality', December 3rd.

⁷ The implementation of the Legal Services Act is being phased in. For example, solicitors have been able to work in legal disciplinary practices since 2009, which allow up to 25% of partners or equivalent managers to be non-lawyers. This change was complemented in 2010 by the Bar Council's removal of restrictions on barristers, such that they could become partners with solicitors in law firms.

⁸ For example, such concerns were raised by the Solicitor Sole Practitioners Group, the Law Society, and the Hampshire Incorporated Law Society, and discussed with the Joint Committee on the Draft Legal Services Bill. See 'Joint Committee on the Draft Legal Services Bill – First Report', chapter 5, July 15th, 2006.

⁹ Respondents were asked to identify the three qualities that were most important to them when choosing a lawyer: 60% chose specialised knowledge of the legal issues involved; 60% chose approachability and the ability to explain; 49% chose cost; 29% chose 'ease of getting in touch'; and 28% chose proximity to where they live or work. See GfK (2010), 'Research on Consumers' Attitudes towards the Purchase of Legal Services', prepared for the Solicitors Regulation Authority, October.

¹⁰ Ministry of Justice (2011), 'Reforming Civil Litigation Funding and Costs in England and Wales – Implementation of Lord Justice Jackson's Recommendations: The Government Response', March.

¹¹ Legal Services Act, Article 83, Section 5, Part b.

¹² See Oxera (2011), 'A Framework to Monitor the Legal Services Sector', prepared for the Legal Services Board, September, footnote 1.

¹³ According to analysis of solicitors' practising certificates. See Oxera (2011), *op. cit.*, Appendix 4 for more details.

¹⁴ These regulatory objectives are described in Legal Services Board (2010), 'The Regulatory Objectives—Legal Services Act 2007', July 15th.

¹⁵ As detailed in Legal Services Board (2010), *op. cit.*

¹⁶ Ministry of Justice (2011), 'Legal Aid Reform in England and Wales: The Government Response', June.

¹⁷ Ministry of Justice (2011), 'Reforming Civil Litigation Funding and Costs in England and Wales – Implementation of Lord Justice Jackson's Recommendations: The Government Response', March.

¹⁸ See, for example, Legal Services Board (2010), 'Improving Access to Justice – Can Changing Regulation Help?', presentation at the 'Regulating and Deregulating Lawyers' conference, June 3rd and 4th; and LawyerLocator (2010), 'The Future of Small Law Firms – Jeopardy or Opportunity?'.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

Other articles in the October issue of *Agenda* include:

- competing with 'free'? The damages of music piracy
- crime doesn't (always) pay: what determines the level of fines?
- the Thomas Cook/Co-op travel agency joint venture: cleared for take-off

For details of how to subscribe to *Agenda*, please email agenda@oxera.com, or visit our website

www.oxera.com