

PS11/17

Financial Services Authority

Authorised professional firms and legal services reform

Feedback to CP11/13 and final rules

Contents

	Abbreviations used in this paper	3
1	Overview	5
2	Summary of responses to CP11/13	8
3	Next steps	14
	Annex 1: List of non-confidential respondents	
	Appendix 1: Made rules (legal instrument)	

This Policy Statement reports on the main issues arising from Consultation Paper 11/13 (*Authorised professional firms and legal services reform*) and publishes final rules.

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Copies of this Policy Statement are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

ABS	Alternative Business Structure
CASS	Client Assets sourcebook
COBS	Conduct of Business sourcebook
COMP	Compensation sourcebook
EPF	Exempt Professional Firm
ICOBS	Insurance: Conduct of Business sourcebook
IMD	Insurance Mediation Directive
FOS	Financial Ombudsman Service
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
MCOB	Mortgages and Home Finance: Conduct of Business sourcebook
MiFID	Markets in Financial Instruments Directive
PROF	Professional Firms sourcebook
SUP	Supervision manual

1

Overview

Background

- 1.1** In July of this year we published Consultation Paper (CP) 11/13, setting out measures to address a future regulatory gap arising indirectly from the Legal Services Act 2007. The Act will establish ‘alternative business structures’ (ABSs), which allow non-law firms to provide legal services and introduce increased flexibility in the management and financing of law firms.
- 1.2** The Legal Services Board will designate licensing authorities for the new structures and these authorities will include some designated professional bodies, whose members carry out financial services as professional firms. If those members are authorised professional firms, they are subject to the rules of both their designated professional body and the FSA for their financial services activities.
- 1.3** A gap is due to arise because the Solicitors Regulation Authority (SRA),¹ has decided that it will not be regulating the financial services activities of proposed future ABSs that are authorised professional firms.² This gap will not exist until the SRA permits the creation of ABSs – expected in the second half of February.
- 1.4** The measures we proposed in CP11/13 would close the gap in consumer protection by removing the exemptions in our rules for professional firms (including ABSs) which are authorised professional firms, but only where the designated professional body does not apply rules covering the firm’s FSA-regulated activities. The measures provide tangible consumer protection – for example, in the case of ABSs under the SRA, compensation if the firm fails.

¹ The SRA is the independent regulatory body of the Law Society of England and Wales, one of the designated professional bodies.

² Professional firms may also carry out financial services activity on an exempt basis, as provided by Part XX of FSMA; however, exempt professional firms are not affected by this issue.

Structure of this Policy Statement

- 1.5 The chapters in this paper cover:
- Chapter 2 – Summary of responses to CP11/13; and
 - Chapter 3 – Next steps

Responses

- 1.6 The consultation period closed on 12 August 2011, and we received 17 responses. Responses (summarised in Chapter 2) were mixed, but overall in favour of our proposal to close the regulatory gap identified. However, a joint response from three of the accountancy bodies³ explained that they do not currently apply their rules to the non-mainstream regulated activities⁴ of their authorised professional firms, as we had assumed.
- 1.7 As a result, we had not considered the impact of this in our cost benefit analysis, and the affected firms would not have enough time to prepare for the changes proposed. We have therefore amended our proposals so the new rules do not immediately apply to the non-mainstream regulated activities of members of the affected designated professional bodies. Chapter 3 sets out our proposed approach for these firms.

Equality and diversity issues

- 1.8 As noted in the CP, we have assessed the equality and diversity impact of our proposals and believe that they are a justified and proportionate means of protecting consumers. We did not receive any substantive comments on these issues.

Who should read this paper?

- 1.9 This paper is relevant to members of the professions who carry out financial services activities on an authorised basis, and to their trade associations and designated professional bodies. It is also relevant to clients of these firms and consumer bodies. Finally, it is relevant to the wider firm population which is subject to and funds the Financial Services Compensation Scheme (FSCS) and Financial Ombudsman Service (FOS).

3 The Institutes of Chartered Accountants in England and Wales, Ireland and of Scotland. Further investigation revealed that this also applies to the Law Society of Scotland and the Association of Chartered Certified Accountants.

4 These activities must meet the conditions in PROF 5.2.1R, and allow firms carrying them out to operate on a level playing field with exempt professional firms, in that a modified FSA regime applies.

Next steps

- 1.10 Subject to the amendment described above, we plan to proceed with the changes proposed in CP11/13. The new rules will come into force on 9 December 2011. We will consult separately in the first half of 2012 on our approach for dealing with the related issue uncovered during our consultation.

CONSUMERS

This paper has implications for customers of professional firms which carry out financial services activities, and consumer groups representing these individuals. The proposals aim to maintain the level of consumer protection that would be present had the SRA's rules for financial services activities been extended to alternative business structures that are FSA authorised.

Without these changes, from February, alternative business structure firms licensed by the SRA and FSA authorised would not be subject (for their financial services activity) to any rules in the areas of compensation and client money. In some cases⁵ there would also be no rule coverage in areas including conduct of business and complaints handling.

The potential benefits are therefore that the clients of such firms remain adequately protected.

⁵ Where the firm carries out non-mainstream regulated activity.

2

Summary of responses to CP11/13

2.1 In CP11/13, we proposed the following changes to our rules:

- For mainstream regulated activities,⁶ we proposed to bring firms carrying out these activities back within the scope of our rules, effectively withdrawing the special exemptions and modifications for this group.
- For non-mainstream regulated activities, we proposed to amend the Professional Firms sourcebook (PROF) so that a professional firm whose designated professional body has switched off its rules for FSA-regulated activities cannot carry out this type of activity. Instead, we would treat the firm as if it conducted mainstream regulated activities, and it would be subject to all FSA requirements. We drafted these changes so they would cover any designated professional body which decides to switch off its rules for FSA-regulated activities in relation to its authorised professional firms, whether they are ABSs or not.

2.2 In this chapter, we report on the responses that we received to the questions posed in CP11/13 and our final position in the light of the responses. We received 17 responses from designated professional bodies, law firms, trade associations, consumer bodies, regulated firms from outside the professions and individuals.

Summary of responses

Q1: Do you have any comments on the equality and diversity impact of our proposals?

⁶ This is equivalent to activity carried out by any FSA-authorised firm, but with limited exemptions and modifications in the areas of compensation and client assets requirements for the authorised professional firms of certain designated professional bodies in the legal sector.

- 2.3 Most respondents offered no comment on this, while several said they did not foresee any adverse impact.

Our response

We maintain our view that our proposals are a justified and proportionate means of protecting consumers.

Q2: Do you agree with our preferred option?

- 2.4 The majority of respondents agreed with our proposals. One respondent agreed with our proposal but would prefer the SRA to regulate the financial services activity of ABSs, and noted that the Legal Services Act would allow this. Another described our preferred approach as a good compromise, while a further respondent noted the importance of addressing the longer term issue of designated professional bodies in the legal sector ceasing to apply their rules to the financial services activity of traditional law firms.
- 2.5 Four respondents did not agree with our proposals. Three raised significant concerns about the impact on non-mainstream regulated activities and argued that they would prevent affected authorised professional firms from carrying out financial services activities. They argued this would be particularly unfair in cases where firms will only become ABSs by default because they had sought to take advantage of part of the limited liberalisation offered by legal disciplinary practices.⁷
- 2.6 They also argued that our approach runs counter to the Legal Services Act's aim to liberalise the profession and the original policy aim of a level playing field between exempt regulated activities and non-mainstream regulated activities.
- 2.7 One respondent suggested that Treasury should simply de-designate any designated professional body which did not regulate the financial services activity of its authorised professional firms.
- 2.8 One respondent suggested that it would be unfair for FSCS levy payers to be liable for the potential costs arising from new authorised professional firm entrants to the FSCS as a result of our proposals, and that the new entrants should be ring-fenced. They also asked us to clarify that compensation for regulated activities conducted before the date these firms become subject to the FSCS would be paid for by the professional body scheme.

⁷ These structures, introduced in March 2010, allowed limited introduction of new management and ownership of law firms, and were used by some solicitor firms purely to allow non-lawyer partners to be appointed. In these cases, under SRA rules they have to become ABSs by November 2012 at the latest.

Our response

As we stated in the CP, it is for the SRA to decide on interpretation of the Legal Services Act. Our proposals recognise the introduction of ABSs and ensure that there is appropriate protection where FSA-regulated activity is taking place. We understand the business implications of our proposed change regarding non-mainstream regulated activities. However, we do not believe that designing a special regime for the affected firms is feasible in the time available, or desirable, due to the disproportionate effort required to create a new set of lighter-touch requirements for non-mainstream regulated activities.

The SRA has already announced that it plans to consult on removing rules for the financial services activity of traditional law firms, so we believe it is right that our proposals should address this eventuality now.

The criteria for designation as a designated professional body relate only to the regulation of exempt professional firms, not authorised professional firms.

We do not agree that we should seek to protect existing levy payers from FSCS costs arising from new entrants. New members will be contributors to the FSCS costs and there would be considerable complexity to implementing ring fencing for a limited number of firms. However, compensation for regulated activities conducted before the date the relevant firms become subject to the FSCS would be paid for by their existing professional body scheme. We have made a minor change to the rules in COMP to make this clear.

Q3: Do you agree with our proposed rule changes?

- 2.9** A narrow majority of respondents agreed with our proposed rule changes. Those in support felt that the changes would deliver our proposed policy approach. One respondent asked us to clarify the addition to PROF 5.2.1R.⁸
- 2.10** Four respondents suggested that we redraft PROF 5.2.1R(6) to reflect the fact that authorised professional firms would not be subject to exempt professional firm rules.
- 2.11** One respondent suggested that changes to our permissions regime might provide an alternative to PROF 5.2.1R(6), bringing a more level playing field between exempt professional firms and authorised professional firms. They also argued that it could deliver cost reduction for firms and the FSA, and potentially help to bring some authorised professional firms into compliance with the rules for non-mainstream regulated activities.
- 2.12** One designated professional body respondent was concerned that our guidance on the term ‘controlled or managed’⁹ in PROF 2.1.5G was not compatible with its own.

⁸ PROF 5.2.1R sets out the conditions for non-mainstream regulated activity. Our proposed addition would limit this activity in order to address the regulatory gap described in the Overview to this policy statement.

⁹ This term is a key part of the definition of ‘professional firm’. The essence of our guidance was to make clear that a manager must have sufficient overall oversight of the firm.

Our response

The aim of our change to PROF 5.2.1R was to restrict the definition of non-mainstream regulated activity (and consequently the modifications enjoyed for non-mainstream regulated activities) to firms which are subject to the rules of their designated professional body for financial services activities. We did this by cross-referring to the designated professional body's rules for its exempt firms.

We have considered whether PROF 5.2.1R(6) needs to be redrafted. While we appreciate the general point that authorised professional firms are not subject to exempt professional firm rules, designated professional bodies can amend their rules to make clear that they also apply to non-mainstream regulated activities, with differences recognised where needed. So we have not changed the drafting.

We have considered whether changing our permissions regime would be a more effective way of delivering our policy aim. First, we should clarify that there are restrictions on the scope of activities of exempt professional firms, as set out in s327 of FSMA and the Non-Exempt Activities Order,¹⁰ and as replicated in designated professional bodies' rules. Consequently, we think that there is a level playing field. The changes proposed to the permissions regime would take considerable resource to implement, and appear to us unnecessarily complex.

Authorised professional firms should be fully aware of, and observe, our requirements for non-mainstream regulated activities and should operate within the scope of their permissions. Nothing we propose changes this basic condition.

The wording of our guidance on controlled or managed applies to individuals, partnerships or bodies corporate, and has the sole purpose of setting the criteria for what is a 'professional firm', in terms of who manages or controls it. It is not intended to describe who controls and manages different types of legal entity. So we do not believe that it conflicts with the definition set out by one of the respondents and have left it as originally drafted.

Q4: Do you have any comments about the costs and benefits set out in Annex 1?

- 2.13** We received seven responses to this question. Three of these noted that in some areas it was difficult to assess whether the costs listed were reasonable, because we had given a range of possible costs. Four respondents felt that we had not fully recognised the impact of the changes for affected firms which are carrying out non-mainstream regulated activity. Their view was that these firms would have to either hive off their financial services activities to a separate entity or cease carrying out the business. One of the four believed that the latter could cause some firms to fail.

¹⁰ The Financial Services and Markets Act 2000 (Professions) (Non-Exempt Activities) Order 2001 (SI 2001/1227).

- 2.14 One of these respondents felt that we had not sufficiently captured the impact on investment business. Three respondents noted that professionalism costs arising from the Retail Distribution Review (RDR) had not been accounted for, nor increased FSA fees as a result of an increased number of approved persons in the firm.
- 2.15 One designated professional body said that additional burdens were being placed on firms at a time when the emphasis is on removing such burdens.

Our response

As noted in the cost benefit analysis, in some areas firms may incur different costs arising from these changes depending on a number of factors which are difficult to predict. We therefore decided to present a range in those cases so that firms could reflect on their own circumstances. We still believe that this is more informative and helpful than averaging out the costs in every case.

Our cost benefit analysis recognised the potential for firms to exit financial services.¹¹ It also set out all potential costs applicable to an affected authorised professional firm, whether it is carrying out investment, mortgage or general insurance business. Given that non-mainstream regulated activity is by definition incidental to professional services, we are not persuaded that these changes are likely to cause a significant increase in firm failures.

We appreciate that, under SRA rules, some legal disciplinary practices have to become ABSs by November 2012 at the latest, and that this will in time increase the expected figure of 12 ABS firms that we showed in the cost benefit analysis. We noted this in our cost benefit analysis.

We do not accept that RDR professionalism costs were not taken into account. The figure of £4,400 per individual for Training and Competence requirements covers a range of approved persons roles, some of which do not have qualification requirements, reducing the cost significantly. The average is enough to cover RDR professionalism costs (as estimated in CP10/14) where applicable. However, we do accept that, depending on firms' activities, FSA periodic fees may rise where our rule changes mean an increase in the number of approved persons. These fees recoup the additional direct cost to the FSA of supervising and administering additional approved persons.

We are unable to quantify the likely total change in fee costs as it is not known how many firms will choose to form an ABS structure falling within the scope of our rule changes, and the number of approved persons will be a decision for individual firms based on their current business needs. Any change in fees will vary according to the activities of the firm, and can be assessed using the fees calculator on our website.¹²

11 Paragraphs 37-41, Annex 1, CP11/13.

12 http://feecalc.fsa.gov.uk/FeeCalc.asp?fy=2011_2012&csc=Final

As noted in the consultation paper, maintaining the current level of consumer protection for future SRA ABS firms is likely to occur at a higher cost for some firms than if SRA regulation provided coverage to ABS firms.

That said, while some firms may face an increase in periodic fees, it is unlikely to be ongoing. We have recently proposed changing the basis of calculation from the fee year 2013/14 onwards¹³ so that periodic fees would no longer be linked to the number of approved persons for any relevant fee block. So while these costs may be material for some firms, where they apply it is likely to be for a limited period only.

General points

- 2.16 Respondents made a range of general comments, many of which were about features of the professional firms regime, and ways in which it could be improved. We appreciate this input, but this consultation was intended to address a specific and pressing issue and did not lend itself to consideration of some of the wider issues.

¹³ We consulted in CP11/21 (October 2011) on changing the basis of periodic fees for some fee blocks (A.12, A.13 and A.14) from a per approved person to a per income basis, from the fee year 2013/14 onwards. Many authorised professional firms occupy these three fee blocks. The other relevant fee blocks are already calculated on a different basis.

3

Next steps

- 3.1** Responses from three of the accountancy bodies¹⁴ highlighted an existing regulatory gap arising because these bodies do not currently apply rules to the non-mainstream regulated activities of their authorised professional firm members. Further investigation revealed that this also applies to the Law Society of Scotland and the Association of Chartered Certified Accountants. We estimate that this affects a maximum of 242 firms.
- 3.2** This gap arose because of a lack of clarity in our rules. The rule changes proposed in CP11/13 would correct this problem, but we did not consider this impact in our cost benefit analysis, and the affected firms and designated professional bodies would have insufficient time to prepare.¹⁵ We have amended our proposal to ensure that these firms are not affected by the new rules, and therefore our original cost benefit analysis is still valid. We will consult separately in 2012 on our approach for dealing with the issue identified. This will also give us and the affected designated professional bodies time to assess potential options to address the problem.
- 3.3** In deciding to delay this change, we have had to balance potential risks to consumers against the practical difficulties of implementing our rules in full at short notice. We recognise that consumers will want us to close any gap as soon as possible. Conversely, firms are likely to argue that the current approach has not led to any known consumer detriment over the past decade. Our view is that there should be adequate consumer protection in all firms undertaking FSA-regulated activities. We will consult on this in the first half of 2012.

¹⁴ The Institutes of Chartered Accountants in England & Wales, Ireland, and of Scotland.

¹⁵ In the designated professional bodies' case this would require, for example, drafting and obtaining Board approval for rules and establishing a supervision programme.

Annex 1

List of non-confidential respondents

Association of Chartered Certified Accountants

Law Society of Northern Ireland

Law Society of Scotland

Institute and Faculty of Actuaries

Law Society of England and Wales

Ernst & Young LLP

Roger Grenville-Jones

Cotswold Financial Services Ltd

The Council of Mortgage Lenders

The Financial Services Consumer Panel

Solicitors Independent Financial Advice

Chartered Accountants Regulatory Body

The Institute of Chartered Accountants in England and Wales

The Institute of Chartered Accountants of Scotland

Iiffes Booth Bennett

Lupton Fawcett LLP

Appendix 1

Made rules (legal instrument)

PROFESSIONAL FIRMS (AMENDMENT) INSTRUMENT 2011**Powers exercised**

- A. The Financial Services Authority makes this instrument in the exercise of:
- (1) the powers and related provisions in the following sections of the Financial Services and Markets Act 2000 (“the Act”):
 - (a) section 138 (General rule-making power);
 - (b) section 156 (General supplementary powers);
 - (c) section 157(1) (Guidance);
 - (d) section 213(The compensation scheme); and
 - (e) section 214 (General); and
 - (2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.
- B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on 9 December 2011.

Amendments to the Handbook

- D. The modules of the FSA’s Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Client Assets sourcebook (CASS)	Annex B
Supervision manual (SUP)	Annex C
Compensation sourcebook (COMP)	Annex D
Professional Firms sourcebook (PROF)	Annex E

Citation

- E. This instrument may be cited as the Professional Firms (Amendment) Instrument 2011.

By order of the Board
8 December 2011

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

- participant firm* (1) (except in *FEES* 1 and, *FEES* 6) a *firm* or a *member* other than:
- ...
- (f) an *authorised professional firm* that is subject to the rules of the Law Society (England and Wales) or the Law Society of Scotland and with respect to its regulated activities participates in the relevant society's compensation scheme;
- ...
- professional firm* a *person* which is:
- (a) an individual who is entitled to practise a profession regulated by a *designated professional body* and, in practising it, is subject to its rules, whether or not he is a member of that body; or
- (b) a *person* (not being an individual) which is controlled ~~and~~ or managed by one or more such individuals.

Annex B**Amendments to the Client Assets sourcebook (CASS)**

In this Annex, underlining indicates new text and striking through indicates deleted text.

5.1.3 R An *authorised professional firm* regulated by The Law Society (of England and Wales), The Law Society of Scotland or The Law Society of Northern Ireland ~~must comply with that, with respect to its regulated activities,~~ is subject to the rules of its designated professional body as specified in CASS 5.1.4R, in force on 14 January 2005, must comply with those rules and if it does so, it will be deemed to comply with CASS 5.2 to CASS 5.6.

...

7.1.15 R (1) An *authorised professional firm* regulated by the Law Society (of England and Wales), the Law Society of Scotland or the Law Society of Northern Ireland ~~must comply with that, with respect to its regulated activities,~~ is subject to the following rules of its designated professional body, must comply with those rules and, where relevant paragraph (3), and if it does so, it will be deemed to comply with the *client money rules*.

...

Annex C**Amendments to the Supervision manual (SUP)**

In this Annex, underlining indicates new text and striking through indicates deleted text.

- 3.10.2 R An auditor of an *authorised professional firm* need not report under this section in relation to that *firm's* compliance with the *client money rules* in the *client money chapter* if:
- (1) that *firm* is regulated by:
 - ~~(1)~~ (a) the Law Society (England and Wales); or
 - ~~(2)~~ (b) the Law Society of Scotland; or
 - ~~(3)~~ (c) the Law Society of Northern Ireland; and
 - (2) that *firm* is subject to the rules of its *designated professional body* as specified in *CASS 7.1.15R(2)*, with respect to its *regulated activities*.

Annex D**Amendments to the Compensation sourcebook (COMP)**

In this Annex, underlining indicates new text and striking through indicates deleted text.

- 5.2.3 R Notwithstanding COMP 5.2.1R, where the *relevant person in default*:
- (1) is an *authorised professional firm* that is subject to the rules of the Law Society (England and Wales) or the Law Society of Scotland; and
 - (2) with respect to its *regulated activities*, does not participate in the relevant society's compensation scheme;
- a *claim* with respect to that *person* is only a *protected claim* if, when the basis for the *claim* arose, that *person* did not participate in the relevant society's compensation scheme with respect to its *regulated activities*.

Annex E

Amendments to the Professional Firms sourcebook (PROF)

In this Annex, underlining indicates new text and striking through indicates deleted text.

- 2.1.5 G Section 327(2) provides that an *exempt professional firm* must be a *member* of a profession or be controlled or managed by one or more *members*. The FSA considers that “managed” here should be read with its natural meaning. However, it may not be sufficient for a compliance manager to fulfil the role of manager, unless that individual is also able to exercise significant management functions involving overall oversight of the operation/business of the relevant person.
- ...
- 5.1.4 G A “*non-mainstream regulated activity*” is defined in the *Glossary* as “a *regulated activity* of an *authorised professional firm* in relation to which the conditions in *PROF 5.2.1R* are satisfied”. Conditions (1) to ~~(5)~~(6) of *PROF 5.2.1R* replicate section 327(1)(b)(i), (3), (4), (5) and (6) of the *Act*, as if those conditions applied to an *authorised professional firm*.
- ...
- 5.2.1 R A “*non-mainstream regulated activity*” is a *regulated activity* of an *authorised professional firm* in relation to which the following conditions are satisfied:
- ...
- (4) there must not be in force any direction under section 328 of the *Act* (Directions in relation to the general prohibition) in relation to:
- (a) a class of *person* which would have included the *firm* were it not an *authorised firm*; or
- (b) a description of *regulated activity* which includes the *regulated activity* the *firm* proposes to carry on; ~~and~~
- (5) the *regulated activity* must be an activity which *exempt professional firms* which are *members* of the same *designated professional body* as the *authorised professional firm* are permitted to carry on under rules made by that body as required by section 332(3) of the *Act*; and
- (6) the *authorised professional firm* is subject to the rules referred to in (5).
- 5.2.1A R The condition at *PROF 5.2.1R(6)* does not apply if the *designated professional body* of the *authorised professional firm* is any of:

- (1) the Institute of Chartered Accountants in England and Wales;
- (2) the Institute of Chartered Accountants of Scotland;
- (3) the Institute of Chartered Accountants in Ireland;
- (4) the Association of Chartered Certified Accountants; and
- (5) the Law Society of Scotland.

PUB REF: 002739

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