

ILEX PROFESSIONAL STANDARDS LTD

CONSULTATION

PROFESSIONAL INDEMNITY INSURANCE AND CLIENT PROTECTION ARRANGEMENTS FOR IPS REGULATED ENTITIES

INTRODUCTION

The Chartered Institute of Legal Executives (CILEx) is an approved regulator under the Legal Services Act 2007. In accordance with the requirements of the Act it has separated out its regulatory and representative functions. The regulatory functions have been delegated to ILEX Professional Standards Ltd (IPS). IPS is the regulatory body for Legal Executives and other grades of CILEx member.

IPS is making an application under the Legal Services Act 2007 for CILEx to become an approved regulator for awarding reserved legal activity rights. IPS would in that way become a regulator of entities through which these legal services are delivered.

IPS needs to ensure it has in place adequate Professional Indemnity Insurance (PII) and Client Protection arrangements for the protection of clients of IPS regulated entities. IPS seeks your views on its proposals for PII and Client Protection. This consultation document outlines IPS proposals. We welcome your views.

This Consultation will close on 19th October 2012

INTRODUCTION

1. IPS is making an application under the Legal Services Act 2007 (the Act) for CILEx to become an approved regulator for awarding practice rights in litigation, probate and conveyancing (the reserved legal activities under the Act). IPS also seeks to make an application to introduce new regulatory arrangements for immigration advisors. IPS would in that way become a regulator of entities through which legal services are delivered.
2. IPS needs to ensure it has in place adequate Professional Indemnity Insurance (PII) and Client Protection arrangements for the protection of clients of IPS regulated entities. IPS seeks your views on its proposals for these arrangements. This consultation document outlines IPS proposals and we would welcome your views.

PROFESSIONAL INDEMNITY INSURANCE (PII)

3. It is essential to protect client interests by ensuring that entities have adequate PII in place.
4. It is our preferred option that entities regulated by IPS will have to obtain PII on the Open Market. In reaching this conclusion, consideration has been given to the alternative option of a Master Policy scheme.
5. We highlight below the differences between a Master Policy and Open Market scheme. Before looking at the two options we consider the issues of minimum terms and conditions, minimum terms of cover and run off cover.

Minimum Terms and Conditions & Minimum Terms of Cover

6. The scope and amount of compulsory cover are key factors to consider when establishing a PII policy.
7. IPS is drawing up minimum terms and conditions of cover. In setting the minimum terms IPS has taken into account that the more broad and onerous the nature of the commitments imposed on participating insurers, the more challenging it is likely to be to secure the interest of insurers to participate in a scheme.
8. It is our proposal that the minimum terms of cover will be set at £2million for all entities. This will not disadvantage entities that are doing low risk work as premiums will be worked out on the level of risk that each entity poses.

Run off cover

What is run off cover?

9. Run off cover must be taken by an entity when it decides to cease practising.
10. Run off cover is a key aspect of protection for entities and, more importantly, clients and former clients of entities regulated by IPS. For this reason we propose that where entities decide to cease practising they will have to take run off cover for a minimum of six years.

The need for run off cover

11. IPS needs to ensure that adequate run off cover is in place, where an entity it regulates ceases to practise. This will ensure that clients of the entity are adequately protected should they realise they have a claim for negligence or breach of contract after the entity has ceased.

Master Policy – run off cover

12. Under a Master Policy scheme it would be a requirement that run off cover for all ceased entities would be provided automatically; this would be factored into the premiums payable by entities.

Open Market Insurance – run off cover

13. Run off cover is more complex in Open Market schemes because there would be no automatic requirement for an insurer to provide continuing cover.
14. IPS must ensure that negligence claims are adequately dealt with, even where the claim arises several years after the cessation of the entity. Under the circumstances IPS would have to ensure that entities who have ceased practising have taken run off for a minimum period of six years.

Master Policy Scheme

What is a Master Policy?

15. Under a Master Policy, individual entities would be required to obtain cover from a single insured Master Policy. The policy would be put in place through a panel of selected insurers who would provide a facility for all entities that require PII. It would be mandatory for regulated entities to obtain cover through such a policy.

16. Coverage provided under a Master Policy would be standardised. The total premium cost would be negotiated with insurers on the basis of expected losses for the whole Master Policy and then allocated to individual entities using a pre-agreed rating calculation.

Advantages and disadvantages of a Master Policy

17. Possible advantages of a Master Policy include:

- It would allow for group purchasing power, which may provide some leverage in the total premium pool, enabling entities regulated by IPS to take advantage of attractive premium levels.
- By using a common process and negotiating with a single panel of insurers, the Master Policy scheme may lead to reduced administrative costs for insurers and entities.
- The policy would provide an opportunity to offer stable premiums over time and to smooth premium fluctuations that may occur from year to year due to changes in investment returns and claims outcomes.
- Cover should be guaranteed for all entities and all types of legal work.
- Automatic run off cover would be provided for entities that cease to practise. Run off cover would remain in place for as long as the Master Policy remained in existence.

18. Possible disadvantages include:

- Entities would not have the freedom to negotiate pricing individually and, while the overall premium pool may be lower, it cannot be guaranteed that there would not be some entities that would have to pay higher premiums.
- There would be no competition therefore entities may not be receiving the most competitive premium available to them.
- All entities regulated by IPS would be entitled to cover, which raises concerns that risks in entities may be missed, and their resultant claims history could affect the pricing of all entities regulated by IPS.
- It may disproportionately benefit smaller or higher risk entities.
- Automatic run off cover would be provided, which may mean that practising entities could end up subsidising entities that had ceased.

Open Market Insurance

What is Open Market Insurance?

19. Under the Open Market, individual entities would be required to obtain cover from a qualifying insurer of their choice. The PII provided must be, at the very least, equivalent to the agreed minimum terms prescribed by IPS.
20. The choice of insurers would be restricted to 'qualifying insurers', who would have committed themselves to the terms of a qualifying insurers' agreement with IPS. This agreement would typically commit insurers to abide by minimum terms and conditions prescribed by IPS.
21. The minimum terms and conditions would be prescriptive, with the aim of ensuring that all IPS regulated entities insure to the same level of cover; and that all claims are dealt with consistently.

Advantages and disadvantages of Open Market Insurance

22. Possible advantages of Open Market Insurance include:
 - The scheme would allow for more competition within the insurance market, allowing a range of insurers to compete for business.
 - Entities would be in a better position to negotiate on price and coverage with a number of insurers.
 - The premiums would be more likely to be based on the level of risk presented or perceived by that insurer. This means that entities demonstrating good risks are more likely to be rewarded and those posing poor risks penalised. This should have the effect of encouraging good practice.
 - It would allow insurers to adjust their rating to reflect the risks posed by entities on an individual basis, which should result in reducing the potential for "good entities" to subsidise "bad entities".
 - There would be more scope for insurers to aim to reward entities that invest in good risk management with lower premiums.
23. Possible disadvantages include:
 - As each entity would be able to negotiate with insurers for multiple quotations, the administrative cost of this process is likely to be higher than for a Master Policy; this cost may be reflected in the premium levels.

- Each insurer would have different premium calculation methods. These may be opaque and prove difficult for entities to understand.
- There may be a significant delay in improved claims experience being reflected in premium levels, as insurers may be reluctant to reduce pricing until they are certain that risks are improving.
- With a range of different insurers, there may be different approaches to the underwriting criteria, risk management and administration. This may make it more complex for individual entities to understand pricing and to take action to enhance their risk profile to gain cover.
- The onus would generally be on the entity to ensure that run-off cover is in place if it ceases to practise. Depending upon what funding may be put in place to provide run-off cover, the provision of cover may be limited and costly.

QUESTIONS (PII)

- 1. Do you have any comments that you would like us to take into consideration when drafting our minimum terms and conditions and minimum terms of cover?**
- 2. Have we effectively dealt with run off cover? If not, why not.**
- 3. What are your views on how we can ensure that entities regulated by IPS will take run off cover on the Open Market when they cease practising?**
- 4. It is our preferred option that entities regulated by IPS will have to obtain PII on the Open Market. Do you think we have adequately addressed the issue of the Open Market? If not, please identify areas that we need to consider further.**
- 5. Do you think our proposals for PII will provide sufficient client protection? If not please tell us why not.**
- 6. Do you have any other comments on the PII proposals? If so, please state what they are.**

CLIENT PROTECTION SCHEME

24. There must be adequate arrangements for the protection of clients. The Act refers to these as compensation arrangements. Compensation arrangements provide redress to clients in the event of dishonesty and/or failure to account to clients by entities regulated by IPS.
25. IPS has explored the options available for providing compensation arrangements. We considered three possible mechanisms:
 - To require entities to deposit all client money within an Escrow;

and/or
 - Have an IPS led Client Protection scheme whereby clients who suffer loss as a result of an entity's dishonesty or failure to account will be able to seek redress from either:
 - a) a Compensation Fund; or
 - b) an Insurance policy.
26. Having considered the three options we take the view that an Insurance policy provides the most suitable mechanism for compensating clients. We are committed to ensuring the option that is the most suitable for entities and therefore propose to keep the arrangements under regular review, should another option become more suitable in the future.
27. In reaching our decision we have considered below the difference between the three arrangements.

Escrow

28. The aim of compensation arrangements is to provide protection against dishonesty or fraud. As most dishonesty and fraud claims involve client money the first option that we considered was how client money could be protected. In this context we explored the Escrow option.

What is an Escrow?

29. An Escrow is a legal arrangement where money is delivered to a neutral third party (Escrow agent) to be held in trust pending the fulfilment of a contract or, in the case of IPS entities, the fulfilment of activities which lead to the trigger of transactions involving client money. On completion of the contract, the Escrow agent delivers the money to the proper recipient, according to the terms of the contract; otherwise the Escrow agent would be bound by a fiduciary duty to maintain the Escrow account.

30. The Escrow agent would be independent of both parties (e.g. the buyer and the seller; parties to a litigation matter; parties in an estate administration) and protects the interests of the parties.
31. We explored the availability and feasibility of Escrow services. We have established that these services are available and that Escrow accounts could be set up.

Objectives of an Escrow

32. The underlying purpose of the Escrow arrangement would be to remove responsibility for the management of client money from entities regulated by IPS; and to pass this responsibility to a third party which must be the subject of close regulatory control elsewhere.
33. This transfers most of the risks associated with holding client money, concentrating them in one place, with those acting as trustees and managers of the accounts. An Escrow arrangement would therefore assist entities in the account management process. The Escrow agent approved by IPS would be required to have in place adequate arrangements to minimise risk and protect client money.

Escrow account management

34. IPS explored mechanisms for an Escrow arrangement. All entities regulated by IPS would be required to deposit all client money with the Escrow agent that IPS nominates. This would therefore prohibit entities from holding client money, providing a consistent approach to handling client money across all IPS regulated entities.
35. Each entity would be registered with the Escrow agent. They would have their own separate client account and within that account have separate client records and separate reference numbers for each client, which the Escrow agent would manage. The accounts would be kept separate by the Escrow agent and would be protected in the event of insolvency of the Escrow agent.
36. The Escrow agent would maintain itemised receipts and disbursements for each transaction for each client of each entity. The agent would supply reconciliation reports to each entity on a monthly basis. In addition the entity would have 'read only' online access to its Escrow account records.
37. The Escrow account would undergo an annual audit, providing an assurance to IPS and to entities that the Escrow agent is maintaining the account in accordance with required procedures.

38. The Escrow agent would be required to properly account for the funds they hold. They would have the responsibility of ensuring that funds are only used for the purpose intended. The agent would also have appropriate systems and checks in place to verify instructions to release funds and to deal with instructions relating to the account.

Costs of an Escrow

39. IPS has explored the costs of holding money in an Escrow. Initial discussions with a potential Escrow agent indicate that an Escrow service may attract charges which could be as high as £12.00 or more per transaction.
40. The expectation would be that all entities regulated by IPS would have to pay such a transaction fee each time they deposit or take money out of the Escrow account.
41. Although there would be considerable savings in respect of reduced activity on account maintenance for entities, charges as high as this could prove to be unsustainable.

Advantages and disadvantages of an Escrow arrangement

42. Possible advantages of an Escrow would be:
- The arrangement reduces the risk of dishonesty and/or theft.
 - The arrangement is likely to inspire consumer confidence because it provides a layer of independent protection for client money, which other accounting arrangements cannot provide.
 - The arrangement provides an assurance to consumers that their money remains protected even where the IPS regulated entity becomes insolvent.
 - The Escrow reduces (but does not eliminate) the need for Compensation Fund/Insurance contributions.
 - The Escrow reduces ledger maintenance and reconciliation work for the entity as the onus would be on the Escrow agent.
43. Possible disadvantages of an Escrow would be:
- The transaction fee costs to entities are likely to be considerably higher than contributions to a Compensation Fund or Insurance policy.
 - Entities would face an added layer of control on the transfer of funds.
 - Entities would need to enter into contracts with the Escrow agent and maintain records with the Escrow agent.

- The Escrow does not eliminate the risk of fraud or dishonesty.
- Reduced contributions would still be required by entities towards a Compensation Fund/Insurance policy.

Compensation Fund

44. IPS has considered a Compensation Fund route as a means of providing consumer redress.

How will the Compensation Fund work?

45. The Compensation Fund would be set up by IPS to make awards to clients who have suffered loss due to fraud or dishonesty by an IPS regulated entity. The Compensation Fund would protect clients who had no other route of redress available.
46. All IPS regulated entities would be required to make an annual contribution to the Compensation Fund. The level of contribution would be determined by the number of practitioners and turnover of the entity. IPS recognises it has an obligation to ensure that the methods of determining contributions are fair and proportionate. Therefore it would keep the method for assessing contributions under review and would adjust this as necessary.
47. Rules would set out the procedure that would be followed where a claim is made to the Compensation Fund. The onus would rest with a client to provide information in support of their claim and to demonstrate the loss they suffered. A client compensated through the Fund would subrogate to IPS their right to make a claim against an entity and would be required to support IPS in making any such claim.
48. The Fund would be a discretionary Fund of last resort. IPS would expect clients to have exhausted all other forms of redress before making a claim against it. IPS would set the maximum payment it can make from the Fund, reviewing this on a regular basis.
49. In assessing what level of payment to make to a client who had suffered loss, IPS would take into account various factors such as whether the client contributed to their loss, failed to act with integrity or failed to co-operate with IPS.
50. Where a client is suffering severe hardship IPS would have reserve powers to make an interim grant. This would be important for providing assistance to vulnerable clients.

51. IPS would have to build up a reserve to deal with Compensation Fund claims. While a reserve is being built up IPS would explore whether other arrangements can be put in place to make funds available to cover losses during this period.

Advantages and disadvantages of a Compensation Fund

52. Possible advantages of a Compensation Fund would be:

- Payments to the Compensation Fund would be determined on the turnover and number of fee earners employed by the entity.
- Risk factors, such as whether entities hold client money should be taken into consideration.
- Payments to the Fund would be built up over time, which could amount to a substantial reserve (and consequently asset) over the years.
- The higher the Compensation Fund reserve, the lower the likely contributions would be needed from entities.
- IPS would be able to determine the maximum payment per claim from the Fund, which could be increased once reserves have been built.

53. Possible disadvantages of a Compensation Fund would be:

- To build a Compensation Fund reserve could take many years.
- The demand on the Fund cannot be determined, which poses the threat that the Fund could run out of money to pay potential claims.
- A large demand on the Fund could mean an increase in contributions.
- Administrative costs of managing the Fund would have to be worked into the contribution payable by entities.
- Contributions by entities would be based upon the size and turnover of the entity, rather than the risk posed by the entity.

Insurance

54. The third option considered by IPS is to put in place Insurance cover for compensation claims.

How will the Insurance policy work?

55. An Insurance policy (not to be confused with Professional Indemnity Insurance) would be held by IPS to cover dishonesty and failure to account by IPS regulated entities. This insurance arrangement would operate in a similar manner to a Compensation Fund, except that claims would be assessed by the insurance provider.
56. All entities would be required to contribute to the cost of the Insurance policy. IPS is working with insurance providers to establish what the premium may be.
57. Claims against the policy would be made as a last resort. Clients would be able to make a claim in the event that the entities PII did not cover the loss.
58. IPS will set the maximum payment that could be made from the Insurance, which would be reviewed on a regular basis.
59. Only clients and former clients would be entitled to make claims.
60. Insurance rules would set out the procedure that would be followed where a claim is made. The onus would rest on a client to provide information in support of their claim; and to show evidence of the loss suffered.

Advantages and disadvantages of Insurance

61. Possible advantages of an Insurance scheme would be:
- Premiums would be determined on the turnover and number of fee earners employed by the entity.
 - Risk factors, such as whether entities hold client money should be taken into consideration.
 - IPS would not need to build a reserve to implement the Insurance policy, which should mean that most claims would be met.
 - The insurer would already have processes in place to deal with claims and potential demands on the policy.

62. Possible disadvantages of a Compensation Fund would be:
- Entities would be paying towards a premium therefore a reserve would not be built over time.
 - The premium would be dependent upon the maximum payment for each claim and the claims aggregate, which are still to be worked out.

QUESTIONS (CLIENT PROTECTION)

- 7. Out of Escrow, Compensation Fund and Insurance policy, what is your preferred option and why?**
- 8. It is our view that an Insurance policy provides the most suitable mechanism for compensating clients. Do you think that an Insurance policy would adequately protect clients' interest in the event of dishonesty and/or failure to account? If not, please identify areas that we need to consider further.**
- 9. Do you think our proposals provide sufficient Client Protection? If not, please state why not.**
- 10. Do you have any other comments on our Client Protection Scheme? If so, please state what they are.**