

## **Consultation: transitioning towards an insurance backed compensation scheme**

1. CILEx Regulation is the independent regulator of specialist lawyers and was established as a regulatory body by the Chartered Institute of Legal Executives (CILEx), an approved regulator under the Legal Services Act 2007 (the Act). CILEx Regulation is the regulatory body for Chartered Legal Executives, other grades of CILEx membership, CILEx Practitioners and entities.
2. This consultation makes a number of proposals to change the CILEx Compensation Fund Rules with a view to moving towards a largely insurance backed compensation scheme as opposed to the maintenance of a substantial fund. This is intended to achieve a more proportionate and cost effective regime while maintaining robust consumer protection.
3. This consultation will run for 8 weeks, closing on 5 May 2017.

## Background: why are we proposing change?

4. Since 5 January 2015 CILEx Regulation has been able to regulate entities whose owners and managers comprise Authorised Persons. This has meant that for the first time members of CILEx can set up their own law firm and provide services which had previously been reserved to other lawyers.
5. We remain committed to promoting this opportunity for Chartered Legal Executives as well as the benefits which CILEx Authorised Entities can offer to consumers through increased competition and diversity in the market place. CILEx membership is uniquely diverse and has the potential to offer competitively priced high-quality legal services.
6. With two years' experience of regulating entities, and reflecting in particular upon the modest numbers of CILEx Authorised Entities to date, we are looking at ways to improve the regime. Specifically, we are seeking views on proposals intended to improve the sustainability of the CILEx Regulation client protection arrangements. We are conscious of current discussions in the context of regulatory independence and the ongoing need to keep the cost of regulation as low as possible. The proposals set out below would permit a greater degree of regulatory independence in the future if needed and would also remove the need for CILEx members (and ultimately consumers) to fund a large pot of money which cannot be used for core regulatory or representative operations.
7. The current client protection arrangements for clients of CILEx Authorised Entities broadly operate as follows:
  - all CILEx Authorised Entities must maintain professional indemnity insurance of £2 million to ensure that clients are compensated if the firm makes a mistake in a client matter (i.e. is negligent and the client loses out as a result);
  - if an entity fails to take out that insurance and a client suffers a loss which, although not arising solely by reason of professional negligence would have been covered by such a policy, then the client can make a claim on the Compensation Fund;
  - if the managers of the entity misappropriate money or fail to account for money (e.g. steal from the client) then the professional indemnity insurance does not cover this. Instead, a Compensation Fund of £1 million provides awards (at CILEx Regulation's discretion) of up to £500,000 per claim to any client or former client who:
    - claims within one year of discovering the problem;
    - suffers hardship as a result of the loss (this will mean in practice that many business clients cannot claim on the fund);
    - cannot claim the monies from anywhere else.
8. This consultation relates to changes to the Compensation Fund. Currently the Compensation Fund is funded in two ways:

- a) £1 million committed by CILEx (the representative body) to meet claims on the Compensation Fund; and
  - b) a policy of insurance which will pay out for claims paid under the scheme up to a limit of £1 million per firm in aggregate and £5 million in total in one year.
9. We had envisaged that the £1 million committed by CILEx to initially establish the Compensation Fund would over time be added to and eventually replaced by Compensation Fund contributions paid by CILEx Authorised Entities. However, the number of CILEx Authorised Entities is not yet at a level for which the entity regulation regime was originally designed. Instead, we have taken steps to increase the levels of insurance available to ensure a robust and sustainable scheme.
10. We would like to expand the use of insurance to become the primary means of funding compensation claims. Our preliminary view is that an insurer would be better placed to respond to an unexpectedly high series of compensation claims (though given current numbers such an eventuality is highly unlikely). We also consider that funding an insurance premium on an annual basis is more sustainable, proportionate and cost effective than seeking to build and maintain a very large fund which cannot be utilised for any other purpose. This would free up financial resources and prepare the foundations for greater regulatory independence should the government require greater separation of representative and regulatory functions in future.

## Our proposals

11. We are proposing to revise our rules so as to enable an insurance backed scheme. The most fundamental changes proposed are to introduce:
- a) means based eligibility requirements on applicants (similar to a number of other legal services regulators) which more clearly place certain larger bodies corporate or registered charities outside the scope of the scheme;
  - b) an aggregate limit on the total value of claims which can be made on the Fund in respect of one law firm of £2 million (commensurate with existing practical limitations in the current scheme); and
  - c) an exceptional circumstances discretion under which the time limits for receiving claims can be extended.
12. We are also proposing to improve the clarity of the rules and move some provisions from current guidance into the rules for the avoidance of doubt. The specific rule changes proposed are contained at **Annex 1. Annex 2** provides an explanation of each material drafting change proposed.
13. Finally, we are also proposing to discuss with professional indemnity insurers their views on adding discretion to the rules which would enable CILEx Regulation to fund the necessary six year run-off professional indemnity insurance premiums for firms which have closed without paying for such cover.

14. Our preliminary view is that an insurance backed compensation scheme will be able to offer a very similar level of protection to consumers and in some respects consumers would be better protected under the proposals. We also consider such an approach to be a more efficient and cost effective use of regulatory funds. However, we are keen to check this thinking with stakeholders and seek views on managing competing objectives in this area where consumer protection issues arise. More detail is set out below.

### Introducing an eligibility requirement for compensation claims

15. Currently any client of a CILEx Authorised Entity can seek to make a claim on the Compensation Fund. A claim may be refused however, if the applicant has not suffered hardship and so larger organisations would be unlikely to be successful in any claim on the fund. Similar to the Solicitors Regulation Authority ('SRA') and some other approved regulators, we are considering limiting the scope of the compensation scheme more expressly to consumers acting in a non-business capacity and to smaller organisations.

16. On a practical level it is unlikely that the changes proposed would have a significant impact upon the protection afforded to clients owing to the need to demonstrate hardship in existing arrangements. We consider that the principle behind this approach, namely that the limited resources available under the compensation scheme should be directed to where it is most needed, remains sound. However we consider that the scheme (as well as firms and clients) would benefit from greater clarity as to which organisations will definitely not be eligible for protection under the scheme. Such changes would also make the scheme easier to insure and remove the need to set aside large sums of money for a fund which cannot be used for any other purpose.

17. We are interested in views of stakeholders both on the principle of introducing such eligibility criteria and also on the point at which a client should fall outside the scope of the scheme. We are currently proposing that the scheme should be limited to claims by consumers and any other person with assets or income/turnover of less than £1million.

18. We consider this cut off point to be appropriate both with a view to achieving the right balance between consumer protection and affordability but also the level at which we would expect a business consumer to be in a position to make more informed choices about how to pursue their legal matter.

19. In light of lack of claims data it is difficult to accurately put a number on how many businesses could be impacted by this proposal. Given the requirement to demonstrate hardship within the existing regime and the typical markets in which current CILEx Authorised Entities operate, we consider it unlikely that this change will have a material impact. However, we recognise that in principle this represents a stricter approach as regards non-consumer clients than a simple hardship test. Hence we are keen to seek stakeholder views on our proposals.

20. The proposed changes can be found in **Annex 1**, rules 6(1) and 6(5).

## Introducing per firm aggregate limits on compensation claims

21. Currently the Compensation Fund is limited to approximately £1 million. Given the current number of CILEx Authorised Entities this sum is unlikely to increase in the short to medium term. One of the advantages of transitioning towards an insurance backed compensation scheme would be the ability of an insurance company to meet varying claim levels. We are proposing to insure the compensation arrangements to a total of £6 million with a £2 million maximum aggregate for claims made in respect of one particular law firm.
22. We have considered data available from other regulators as a means of seeking to gauge as far as possible in the absence of claims data for our own market what the likely impact of such a change would be. It is understood that the Council of Licensed Conveyancers (CLC) on average pay out £30,000 to £40,000<sup>1</sup> per successful claim. It is perhaps worth noting in this context that CILEx Regulation is unlikely to be exposed to the same number of claims per entity as the CLC, given that it regulates lower risk work than purely conveyancing and probate (though it does also authorise firms in those areas). It has been difficult to find data on the total number of claims per firm but based upon the data available as described above and information obtained anecdotally it appears highly unlikely that an aggregate limit of £2 million would be exceeded. Indeed, this was the basis upon which the Compensation Fund was initially established with a pledge of £1 million by CILEx.
23. On a practical level the approach proposed would also have a neutral impact upon consumer protection as compared with existing arrangements. This is because currently the scheme is already limited in practice to £2 million per firm (£1 million being the total of the fund plus insurance with a £1 million per law firm aggregate limit). However, in order to move towards a largely insurance backed compensation scheme we would propose expressly to limit the sum which could be paid in aggregate in respect of one particular firm within the rules (i.e. to £2 million per firm).
24. In the unlikely event of eligible claims exceeding funds available then pro rata or nominal payments may need to be made (similar as to what would occur currently if the £1 million fund were to be exhausted). We are proposing guidance for decision makers on what to do in such a scenario to the effect that if it appears that an aggregate limit may be reached:
- urgent grants should be made on an interim basis until the fund is in a position to estimate the likely total exposure to the fund; and
  - where necessary all claims would be settled on a pro rata basis depending upon the proportion of funds available to settle the eligible claims made.
25. The proposed change can be found in **Annex 1**, rule 9(2). We welcome stakeholder views on our analysis and proposed approach on this point.

## Funding run-off insurance where firms are in default

26. Under the current arrangements losses which arise solely by reason of professional negligence cannot be compensated for via the Compensation

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<sup>1</sup> <http://www.legalservicesconsumerpanel.org.uk/ourwork/Financial%20Protection/FPAs%202013%2006%2010%20final.pdf>

Fund if, for example, the CILEx Authorised Entity has failed to maintain insurance. In order for a grant to be made, the losses would need to arise at least in part as a result of something more than a simple error (such as recklessness or deliberate wrongdoing on the part of the firm or individual).

27. Insurers are required to notify CILEx Regulation where a firm fails to pay for its six year run-off insurance premium to cover claims discovered after its closure. We would like to discuss with professional indemnity insurers whether they would be prepared to accept payment of a run-off insurance premium quoted to the firm from the Compensation Fund or from CILEx Regulation in the event of a failure by the firm to pay it. We would of course also pursue the firm for such costs where feasible and consider whether regulatory action is appropriate for such a failure. If implemented, this approach would increase the levels of consumer protection available. While we consider that this could be a practical and cost effective means of increasing consumer protection where risks actually crystallise, we are conscious also of the possible perception of rewarding regulatory failure. While further work would be needed with professional indemnity insurers to properly assess the feasibility of such an approach, we are interested nonetheless to seek stakeholder views on the broad principles of such a proposal.

#### **Incorporating a discretion to extend time limits for submitting claims**

28. Currently the rules set a strict one-year time limit for clients to make claims under the scheme. On reviewing the rules we consider that it would be beneficial for decision makers to have exceptional circumstances discretion to extend the time limit within which a claim may be made. This would be in case unforeseen problems prevent a claim being made earlier e.g. a sustained period of incapacitation through poor health.

29. The proposed change can be found in **Annex 1**, rule 7(1)(b).

#### **Other changes proposed**

30. We also proposing to make a number of other changes to the rules which would have a lesser impact than the areas already discussed in more depth. Many of these other changes are either consequential to the more substantive points discussed in this consultation or relate to ensuring clarity rather than a shift in approach. These other changes include:

- stating more clearly that acts or omissions of employees of CILEx Authorised Entities and losses arising from reserved and unreserved work of a type which the firm is authorised to conduct come within the scope of the scheme. This is intended to minimise the risk of a consumer's claim being rejected where a literal interpretation of the rules is applied in a way which is not in keeping with the spirit of the scheme;
- requiring applicants for grants on the fund to pursue alternative remedies and enquiries in all cases save where it would be unreasonable to do so. Currently, decision makers would generally be expected to exercise a discretion requiring such steps to be taken. However, it is only a discretion at present. Given the nature of the



Fund we consider that it would be more appropriate for the starting point to be that steps be taken to fully investigate alternative remedies. Instead, we consider that discretion should exist to waive this default position where the claim is for an interim grant, or there is no reasonable prospect of successful recovery, or similar good grounds for not doing so before a grant is made. As well as more closely representing the intended policy in this area this change would also assist in moving towards a primarily insurance backed regime; and

- to incorporate certain aspects of existing policy/guidance into the rules. For example, the new rules would expressly allow for interim payments to be made in urgent cases and also put beyond doubt that grants cannot be made in excess of available funds. Such changes do not however represent a shift in policy or approach.

31. Further detail on these changes can be found in **Annex 2**. **Annex 2** sets out each of the material drafting changes proposed to the rules (**Annex 1**) together with the rationale for each revision proposed.

## Consultation questions

The questions are listed below. Please provide your responses on the response form provided and provide reasons for your answers.

Q1. Do you agree with our proposal to transition towards a largely insurance backed compensation scheme rather than continuing to rely on a large fund?

Q2. Do you agree with our proposal to introduce eligibility criteria and the threshold proposed for placing certain organisations outside the protections of the compensation arrangements?

Q3. Do you foresee any issues with CILEx Regulation seeking to fund professional indemnity insurance run-off premiums where firms are in default but continue to incur liability?

Q4. Do you agree with our proposal to introduce a £2 million aggregate limit on the value of claims which can be made under the compensation arrangements in respect of one firm?

Q5. Do you have any other comments on the drafting proposals set out at **Annex 1** in the context of how the new approach would be implemented and the other changes proposed to the rules?

## How to respond

A response form has been provided for completion. Please send the response form to CILEx Regulation through one of the following methods:

- By email to [consultations@cilexregulation.org.uk](mailto:consultations@cilexregulation.org.uk) Mark it for the attention of Jill Durham.
- By responding online at the following link <https://www.surveymonkey.co.uk/r/R768M23>
- By post to CILEx Regulation Ltd, Kempston Manor, Kempston, Bedford MK42 7AB.
- By DX to CILEx, DX 124780 Kempston 2.

### **Submission deadline**

The deadline for the submission of responses is 5 May 2017.