



**Understanding the economic  
rationale for legal services  
regulation -  
A collection of essays**

**March 2011**

## Foreword

Last year we took the decision to take a step back from the existing regulatory structures and consider the underlying purpose of regulation of legal services, the legal services professions and the legal services market. We commissioned Chris Decker and George Yarrow from the Regulatory Policy Institute to write a report summarising what economics in particular can teach us. This report was never intended to be the last word on the subject, but we hoped that it might spur debate and lead to greater academic interest, both in and beyond law schools, in the topic of legal services regulation.

We are publishing this report, together with this collection of essays which provide responses from a variety of perspectives, at a fascinating time in the development of the regulation in legal services, both in England and Wales and indeed globally. The combination of moves towards Outcome Focussed Regulation and Alternative Business Structures on the one hand and economic and technological changes on the other present both the sector and regulators with significant challenges. In this changing world, there is a major task for regulators, not just to ensure the highest standards of performance, but to ensure that the regulatory framework they administer is proportionate, targeted and fit for purpose.

Recent papers published by Professor Stephen Mayson at the Legal Services Institute have highlighted both the patchwork development of existing legal services regulation in England and Wales and the scope for change and modernisation. . We recognise these challenges and in our early work have already been faced with calls for changes to the regulation of referral fees and wills. For the LSB this debate is essential, as oversight regulator our objective is to ensure proportionate and effective regulation of legal services, always based on the strongest hard analytical evidence, rather than individual “horror stories”.

It is with great pleasure therefore that the essays we are publishing in this compendium demonstrate interest and challenge from a wide selection of academic fields beyond the economic topic of the report itself. We are grateful to all those who have contributed and believe that the resulting collection of essays provide a challenging discussion of the issues raised in the Decker and Yarrow report. Together, we believe that they help to define a strong theoretical analytical base, not only to tackle some of the specific practical challenges we and the Approved Regulators face in this jurisdiction, but to the development of legal regulatory debate and practice internationally.

Chris Kenny

Chief Executive

Legal Services Board

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Alex is Research Manager at the Legal Services Board. Previously he has held a variety of policy, research and economics roles in the Association of British Insurers and Government departments.

## **2. Understanding the Economic Rationale for Legal Services Regulation: The Importance of Interdisciplinary Dialogue**

### **Professor Laurel S. Terry, Penn State Dickinson School of Law**

Professor Laurel Terry is a leading scholar of legal ethics and the international and inter-jurisdictional regulation of the legal profession. A three-time Fulbright grant recipient, her research interests include global regulatory initiatives, including recent structural reforms in Australia and the UK, the application of the World Trade Organization's GATS agreement to legal services, lawyer confidentiality and the Financial Action Task Force (FATF) recommendations, and the effect of the Bologna Process on legal education. Professor Terry teaches Professional Responsibility, Civil Procedure and a seminar on Cross-Border Legal Practice.

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### **Professor Julia Black, Department of Law, London School of Economics and Political Science**

Julia Black joined the Law Department at the London School of Economics in 1994. She completed her first degree in Jurisprudence and her DPhil at Oxford University. Her primary research interest is regulation. In 2001-2 she received a British Academy / Leverhulme Trust Senior Research Fellowship to develop her work on regulation, and in 2007-8 was a Visiting Fellow at All Souls College, Oxford. She has written extensively in the area of regulation, and also advised policy makers, consumer bodies and regulators on issues of institutional design and regulatory policy

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### **Professor Richard Moorhead, Cardiff Law School, Cardiff University**

Richard Moorhead's main research interests are legal aid, no win no fee arrangements, the courts, the legal profession, regulation of professions and legal systems and socio-legal research methods. He has conducted a number of evaluations of legal service programmes as well as theoretically informed empirical research into the courts and the legal profession. He teaches an undergraduate course on lawyers: practice and ethics and an LLM course on commercial legal practice.

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### **Professor Paul Maharg, Northumbria Law School, Northumbria University**

Paul Maharg is Professor of Legal Education. He joined the Law School in February 2010 from Strathclyde University where he was Professor of Law in the Law School. His first degrees were in the Arts – literature & aesthetics – and he graduated LLB after seven years in adult education. In the

Glasgow Graduate School of Law at Strathclyde he was Co-Director of Legal Practice Courses, and Director of the innovative Learning Technologies Development Unit in CPLS. He has published widely in the fields of legal education and professional learning design. His specialisms include interdisciplinary educational design, and the use of ICT at all levels of legal education. He consults with legal service employers and regulatory bodies.

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### **Professor Julian Webb and Abby Kendrick, Warwick Law School, Warwick University**

Julian Webb, BA (CNA), LL.M., LL.D. (Warwick), FRSA, FHEA, is Professor of Legal Education, Director of the Higher Education Academy UK Centre for Legal Education, and a Senior Associate Research Fellow of the Institute of Advanced Legal Studies, University of London. Julian is currently a member of the Executive Committee of the Socio-Legal Studies Association and from 2004-2008 was chair of its Research Ethics Sub-Committee.

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### **Russell Wallman and Nick Denys, The Law Society of England and Wales**

Russell Wallman is Director of Government Relations at the Law Society. He is responsible for the Law Society's relationships with the Legal Services Board and with the Society's own regulatory arm, the SRA; as well as for overall management of the Society's relationship with Government, and particularly with the Ministry of Justice.

Nick Denys is a policy adviser in the Government Relations Directorate of the Law Society. During 2009 Nick was part of the team led by Lord Hunt of Wirral that produced the report: "Enduring Principles, Professional Standards, Appropriate Regulation: Modern Professional Regulation for Law Firms."

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### **Professor Cosmo Graham, School of Law, Leicester University**

Cosmo Graham is a competition lawyer and a public lawyer who specialises in the law relating to the regulation of public utilities. He is the Director of the Centre for Consumers and Essential Services (CCES). He was a member of the Competition Commission from 1999 to 2008.

## **9. The consumer's role**

### **Steve Brooker, Legal Services Consumer Panel**

Steve manages the Legal Services Consumer Panel, he was formerly Head of Fair Markets at Consumer Focus where he managed a policy and public affairs team working on a wide range of issues including financial services, the digital economy, consumer law and sustainable consumption. Prior to that, he led the National Consumer Council's policy work on regulation and civil justice. His previous career was in university administration with roles at Keele and the London School of Economics.

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### **Alex Roy, Legal Services Board**

**Legal Services Board discussion of a report by Dr Christopher Decker & Professor George Yarrow**

**Alex Roy**

**Legal Services Board**

**Introduction**

This paper provides the Legal Services Board's (LSB) summary of an economic study commissioned from Decker and Yarrow from the Regulatory Policy Institute (RPI)<sup>1</sup>. The study explores the economic basis the use of why regulation in the legal market and how legal market regulators should approach their analysis for changes to regulation.

Why is the LSB interested in such matters? The LSB takes its approach to oversight regulation from the Regulatory Objectives set out in the Legal Services Act 2007<sup>2</sup>. The LSB must seek to ensure regulation both protects and promotes consumer interests while minimising the burden of regulation that inevitably raises costs for the consumer it seeks to protect. We must also carry out our work with reference to the Better Regulation Principles (transparent, accountable, proportionate, consistent and targeted) and the broader social and political drivers to minimise regulatory burdens.

The LSB has been given, by statute, the responsibility to change the scope of regulation allowing new activities to be reserved<sup>3</sup> or by removing reservation from other activities. Within initial two years of operation the LSB has already responded to calls extend the scope of regulation – firstly from demands for referral fees to be banned, then more recently is considering calls for will-writing to be brought within the scope of regulation. The scope of legal services regulation is defined by the activities that are 'reserved'<sup>4</sup> and the people who are 'authorised'<sup>5</sup> to carry out such reserved activities. Authorisation, to carry out any of the reserved activities, is linked to specific individuals with regulation then attached to those authorised persons, often even beyond their reserved activities.

The LSB must ensure that regulation represents the needs of the public and consumers of services. This economic study will help the LSB in developing a framework for assessing the merits of changes to the regulatory framework.

Decker and Yarrow set out a theoretical approach to understanding the economics of the need for regulation in legal services. The LSB will need to supplement this theoretical work with quantitative and qualitative research when we test actual outcomes in specific areas of law, for different types of consumer. At this stage, our approach goes as far as recognising this need without outlining particular areas for further analysis or a proposed quantitative

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<sup>1</sup> Decker, C & Yarrow, G; "Understanding the economic rationale for legal services regulation", Regulatory Policy Institute, October 2010

<sup>2</sup> <http://www.legislation.gov.uk/ukpga/2007/29/contents>

<sup>3</sup> Reservation restricts the practice of certain activities to those who are authorised by Approved Regulators

<sup>4</sup> Reserved activities are: exercise of right of audience; conduct of litigation; reserved instrument activities (e.g. conveyancing); probate activities; notarial activities; the administration of oaths.

<sup>5</sup> For example: solicitors, barristers, licensed conveyancers, notaries, trade mark attorneys, patent attorneys, legal executives etc.

approach, although our forthcoming business plan for 2011-12 will set out further thinking on priorities.

This summary is the LSB's interpretation of the report by Decker and Yarrow and therefore does not necessarily represent the views of the authors which are best summarised in the report itself.

### **Analytical approach**

A common approach to this challenge in economic literature would be to use market failure analysis. Looking for deviations from a perfect market and suggesting the types of intervention that might correct for these deviations. Instead, Decker and Yarrow use an approach the economic literature refers to as "institutional economics". Here, instead of assuming that all deviations from an abstract definition of perfect competition are things to be corrected, the economic literature assumes that there is no perfect market. Issues, which elsewhere might be considered *failures*, are in institutional economics literature considered as *features* of the market, the institutions and regulations, simply the 'rules of the game'.

This shifts the nature of the discussion from one about perfect versus imperfect markets to a discussion about the nature of regulation and the impact of specific rules or regulations on public interest. This analysis treats statutory regulation as an equal part of an overall regulatory puzzle, alongside other factors such as culture, law etc. Tools to address any problems identified are drawn from a wide variety of potential interventions, many of which will not involve statutory regulation.

The paper therefore considers the need for regulatory intervention from first principles, but uses a "real world" context to ensure that recommendations are practical and grounded. So, for instance, Decker and Yarrow do not assume that regulation should be assessed against a blank canvass, but instead assesses the need for regulation *given* the existing professional and regulatory market structures. The institutional economics approach considers differences in knowledge an essential feature of the market that has led to the need for the specialist skills of lawyers. The features of the market are therefore only considered as problems that should be addressed where there is actual harm to economic or policy objectives or at least strong potential for harm.

The approaches of market failure and institutional economics are quite different, yet many of the analytical tools used are similar. Even a market failure approach must consider the efficacy of regulation as a solution before recommending an intervention. The institutional economics approach simply avoids making many of the initial assumptions made in a perfect competition model. Furthermore, the institutional economics model considers statutory regulation as part of a wider system of regulation, encompassing profession rules and trading norms. In both the market failure and institutional economics models actual regulatory intervention is limited to cases where the cost of intervention is weighed against the benefits intervention would be likely to achieve. Ideally, unnecessary or ineffective statutory regulations are removed allowing market forces to operate.

## **What is regulation?**

A central premise of the analysis by Decker and Yarrow is that the application of regulation should be seen in its widest context. Rules and associations represent part of the regulatory framework as much as the formal regulation through reservation of title to an authorised person. In this wider interpretation, the theoretical objectives of regulation are shared objectives for whoever instigates regulation. Key, obvious, differences in regulatory approach will come from the incentive structure of those making rules or forming associations. In terms of the implications for our analysis the conclusion reached is simply that it is not possible to hypothecate a world with no regulation when assessing the need for public regulation. Instead, all public regulation must be assessed in the structural context of the market itself – with the existing rules, professional associations, traditions etc., which have very important impacts on the conclusions emerging from any analysis.

## **The importance of law**

The particular nature and importance of law is central to the case for regulatory intervention – whether by the forming of professional bodies or more recently in the desire to ensure independent regulation. The extent to which law is unique, particularly distinct from other professional services or simply one of a number of services that require specialist knowledge or skills is considered in the report. Certainly legal services frequently deal with matters that can have a high importance for a consumer, with outcomes often affecting consumers' rights, property or even liberty. The irreversibility of the outcomes from many legal services make the need for an absolute guarantee of quality of service extremely important in subsequent LSB analysis of potential changes to the scope of regulation.

Legal services are also part of the broader social-political-moral landscape that underpins the fabric of society. The importance of good provision of legal services (whether measured by quality, price or accessibility) therefore holds greater significance than might be attributed to other professional services. Users and suppliers of legal services are varied with the state both at central and local government levels acting as both suppliers and purchasers of legal services. This public interest test for regulation is distinctly different to analysis of many other sectors where this type of analysis is used.

While acknowledging the importance of legal services we must also recognise that the features seen in legal services are in no way unique to this sector. It can equally be argued, and perhaps more strongly since the financial problems of 2008, that credible and effective accounting and auditing frameworks or financial services market regulation is essential to the stability of our financial and economic model. Many similarities exist in other less obvious comparisons, the paper highlights the parallel of law with the driver of a school bus where mistakes by the driver can have irreversible and unthinkable consequences. Law is certainly important, but not necessarily unique.

## **What should regulation achieve?**

The origins of regulation are commonly public policy concerns – whether fixing opening hours so consumers know when they can use the service or fixing minimum quality to protect consumers from poor service. Economic theory divides public policy concerns into issues of efficiency and equity. Outside of economics, policy makers consider a further issue of distributive justice where they desire a service to be available to all regardless of affordability. Public policy in regulating then becomes a balancing act where regulations try to achieve the best balance between the different objectives given wider government objectives and affordability concerns. Economic tools can be used to develop a framework for assessing the efficacy of the regulatory tools used to address these public policy concerns.

Efficiency concerns can broadly be seen as the challenge of producing the maximum value of product and service for the minimum value of input. In translation in a modern capitalist economy (such as the UK or US economies), this is commonly addressed by seeking to ensure competitive markets, allowing the market to allocate resources (money, physical assets etc.) where it finds the greatest value. Regulation is often introduced where markets if unregulated tend towards a single provider (monopoly) lacking the competitive pressures which would be expected to deliver an efficient allocation of resources. The regulation attempts to act as a proxy for the effects competitive pressures by attempting to secure the same outcomes.

The institutional economics approach recognises the complexity of markets in practice, avoiding any assumption that achieving perfectly competitive markets is in any way a realistic or necessary objective. Instead, it attempts to harness economics to consider potential regulatory tools in complex, heavily regulated markets.

Economics is also concerned about issues of equity, most notably around artificially high prices (compared to a competitive market) or discriminatory pricing that functioning competitive markets would eliminate. An inequitable outcome in a market will often lead to many groups of consumers being unable to access the market at an affordable price. Asymmetry of information can exacerbate problems of access by creating opportunities for discriminatory charging by suppliers who can take advantage of consumers lack of knowledge by supplying more of their service than necessary, or a service with higher quality inputs than necessary and/or higher prices. In particular markets, not least legal services, problems of consumer access are of particular importance for policy makers and regulators. Indeed, for policy makers lack of access can be so important as to make it a separate category of concern alongside efficiency and equity. Regulatory solutions to address access can be particularly interventionist, either through price controls or in the case of legal aid, publicly funding access. The wider public role of legal services makes access to justice a particular priority for regulators.

Given the presence of professional associations representing public interest as well as the interests of the profession many question the need for formal regulation at all. One particular aspect of economic theory that helps us consider this challenge is the Envelope Theorem.

The paper considers how the theorem can be used to illustrate some of the problems inherent with self-regulation. In broad terms, the application of the theorem notes that a regulatory body will generally attempt to maximise social welfare from its application of regulations, where social welfare encapsulates benefits to both consumers (actual and potential) and people working in the profession itself. But, within this overall welfare maximisation, benefits may not be equally shared between consumers and the profession. Indeed the envelope theorem hypothesises that self regulation, while maximising efficiency, can fail to achieve equity, prioritising the needs of the profession at the margin over consumers. It postulates that even a marginal prioritisation of the needs of the profession (even subconsciously) can have a disproportionately large impact on the benefits to consumers providing a significant argument for independent regulation.

This theoretical finding is not based on a premise that professions deliberately attempt to put the interests of their profession above the consumer. For illustration, imagine a regulatory intervention by a self regulatory body designed to ensure quality for consumers, but which achieves this at the expense of restricting access for consumers by restricting supply and so raising the price a profession were able to charge. Quality is raised, but the greatest share of the benefits is captured by the profession through higher charges. This theoretical finding is supported in part by quantitative studies from the US that explore the differential incomes for those inside and outside of a profession. The finding that average earnings of professional workers were substantially higher than non-professional workers, allowing for relative skills etc., supports the conclusion that professions have, in some cases, served to increase their own wages. While not surprising, the envelope theorem, and supporting empirical evidence suggest that self regulation will, on its own, have a tendency to privilege the interests of the profession over those of the public.

### **Uniqueness of legal regulation**

Law, in common with the other professions, retains a particular regulatory structure much separated from those in the wider economy. Many of the behaviours and rules about what it means to be a lawyer come from professional bodies sitting outside of the public sector. In recent years, the formal regulation of lawyers has been delegated from these professional bodies, but the informal rules and behaviour that govern much of the de-facto regulation of legal services remains with professional bodies. These customs, educational standards, behaviours etc. have grown up over hundreds of years and are as ingrained in what it means to practice law as any formal regulation and so are just as important when considering to change formal regulation.

Alongside the growth and development of the professions as non-statutory regulators of legal services has been an increased role for parliament and the state in granting exclusive rights to practice certain legal activities to specific professional groups. As highlighted in Stephen Mayson's paper<sup>6</sup> the choices made in reserving specific activities were not formed from a specific developed framework assessing the economic impact of reservation. While over time this state backing for professional regulation has increased, the Legal Services Act 2007 marks a watershed where a single public sector regulator has been given an explicit

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<sup>6</sup> Mayson, S, "The Regulation of Legal Services: Reserved Legal Activities: History and Rationale" Legal Services Institute, August 2010

mandate to consider the scope of regulation and rules being introduced by the whole range of regulators and professional bodies –both those with designated powers and others.

But, it is necessary to recognise that the fragmented nature of customer and suppliers creates problems in achieving the aims of efficiency, equity and access. Both existing practice and the preference of many, although arguably a declining number of, customers is for face to face advice, necessitating the geographically fragmented supplier base. Differences in providers, customers and services offered will all interact to complicate analysis of the use of regulatory interventions. As if not complicated enough, regulation of legal services mixes regulation based on service, person and title, leaving some areas doubly regulated and in other areas complete absence of regulation.

### **In conclusion**

In their paper Decker and Yarrow use economic theory to illustrate the complexity of analysing regulatory changes in legal services. A clear conclusion from their work is the need to ensure empirical analysis underpins regulatory decisions. Any regulatory interventions must take account the complexity of the market, interventions are likely to have a very different impact on large and small firms, between domestic and large business customers and conveyancing and high court advocacy. Difference between segments of legal services are significant and solutions to identified problems in the market are likely to need to be tailored to the individual segments. This segmentation is further complicated by the presence of the mixture of professional associations and regulators present in the legal services market.

Decker and Yarrow highlight the need to maintain a standard of quality of service as perhaps the most compelling reason for regulation of legal services. The importance of legal services to individual customers and more broadly the public interest in confidence in the law and legal processes makes such consideration central to any change in regulation.

The LSB will need to draw together the key strands of thinking highlighted in the paper together with other literature to form its framework for assessing regulatory change. Our role is to recommend to the Lord Chancellor where changes are needed to the scope of reservation (whether extending or reducing regulation). Cost benefit analysis as summarised in particular in HM Treasury's Green Book will remain central to our analysis, but the specific nature of legal services will continue need to be equally integral to all our analysis.

## Understanding the Economic Rationale for Legal Services Regulation:

### The Importance of Interdisciplinary Dialogue

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As a U.S. legal academic who specializes in lawyer regulation issues, I initially approached with trepidation the Legal Services Board-commissioned paper entitled *Understanding the Economic Rationale for Legal Services Regulation* (“the Decker-Yarrow Paper”).<sup>8</sup> Although I believe the legal profession could benefit by a more rigorous understanding of regulatory theory and a rigorous examination of its regulatory policies, I also believe that some of the recent efforts have been less nuanced than is ideal. For example, in my view, the early efforts of the OECD’s *Services Trade Restrictiveness Index* (STRI) and the study that formed the basis of the European Commission’s *Report on Competition in Professional Services* insufficiently took account of some of the context-specific issues involved in lawyer regulation.<sup>9</sup> Thus, on the one hand, when I was first asked to contribute an essay to this *Compendium*, I was pleased to be included because I believe it is important for legal profession experts, legal ethics experts, regulatory theory experts, and economists to have a more in-depth and engaged dialogue with each other than generally has happened. On the other hand, I was nervous about exactly what I was going to find once I read the paper and whether the paper and my reactions would – in essence - be “ships passing in the night,” in

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<sup>7</sup> Harvey A. Feldman Distinguished Faculty Scholar and Professor of Law, Penn State Dickinson School of Law, USA. Professor Terry would like to thank Alex Roy for inviting her to participate in this Compendium and Carole Silver for useful comments on a prior draft. Professor Terry can be reached at [LTerry@psu.edu](mailto:LTerry@psu.edu). Her articles and presentations are available as links from this webpage:

<http://www.personal.psu.edu/faculty/l/s/lst3/>. All links in this article were available as of February 10, 2011.

<sup>8</sup> Christopher Decker & George Yarrow, *Understanding The Economic Rationale For Legal Services Regulation* (Oct. 31, 2010), available at [http://www.legalservicesboard.org.uk/news\\_publications/publications/index.htm](http://www.legalservicesboard.org.uk/news_publications/publications/index.htm) [hereinafter “the Paper.”]

<sup>9</sup> Organization of Economic Cooperation and Development (OECD), *Indicators of Regulatory Conditions in the Professional Services*,

[http://www.oecd.org/document/24/0,3746,en\\_2649\\_37421\\_35858776\\_1\\_1\\_1\\_37421,00.html](http://www.oecd.org/document/24/0,3746,en_2649_37421_35858776_1_1_1_37421,00.html). See, e.g., Iain Paterson, Marcel Fink, Anthony Ogus, Et Al., Institut für Höhere Studien (IHS) *Research Report: Economic Impact of Regulation in the Field of Liberal Professions in Different Member States: Regulation of Professional Services: Study for the European Commission, DG Competition: Final Report—Part 1—Main Report* (2003), available at

[http://ec.europa.eu/competition/sectors/professional\\_services/studies/prof\\_services\\_ihs\\_part\\_1.pdf](http://ec.europa.eu/competition/sectors/professional_services/studies/prof_services_ihs_part_1.pdf).

For additional information on the OECD’s STRI project and the EU Professional Services Competition Initiative, see Laurel S. Terry, *The European Commission Project Regarding Competition in Professional Services*, 29 Nw. J. INT’L L. & Bus. 1, 69, 95-97 (2009) (discussing, inter alia, the Henssler/Kilian report that criticized the IHS report methodology); Laurel Terry, *The Future Regulation of the Legal Profession: The Impact of Treating the Legal Profession as “Service Providers”*, 2008 J. PROF. L. 189, 190-91 (2008); OECD, Experts Meeting on the Services Trade Restrictiveness Index (STRI) Services Trade Restrictiveness Index, (July 2009) (including sessions on the development of an STRI index for professional services),

[http://www.oecd.org/document/53/0,3746,en\\_2649\\_36344374\\_46257909\\_1\\_1\\_1\\_37431,00.html](http://www.oecd.org/document/53/0,3746,en_2649_36344374_46257909_1_1_1_37431,00.html) (STRI project); EU DG Competition, *Professional Services Sector*,

[http://ec.europa.eu/comm/competition/sectors/professional\\_services/overview\\_en.html](http://ec.europa.eu/comm/competition/sectors/professional_services/overview_en.html); CCBE, Competition Committee, [http://www.ccbe.eu/index.php?id=94&id\\_comite=4&L=0](http://www.ccbe.eu/index.php?id=94&id_comite=4&L=0) (includes links to various studies about the legal profession).

which neither side engaged the other with respect to the issues that side considers important.

In light of my concerns, I was very pleased to discover that my fears were unfounded. ***Understanding the Economic Rationale for Legal Services Regulation*** (“the Decker-Yarrow Paper”) is a thoughtful contribution to the legal profession regulation literature and will be a useful focus for stimulating discussion among groups that have, in my experience, had too little direct dialogue with one another. There were a few areas in which I disagreed with the Decker-Yarrow Paper and a few areas where I wish the Decker-Yarrow Paper had expanded upon its analysis. Overall, however, the Decker-Yarrow Paper is an important contribution to a still relatively undeveloped interdisciplinary dialogue among legal profession experts, economists, and regulatory reform experts. The Decker-Yarrow Paper should provide a useful springboard for a wider debate about the future shape and role of lawyer regulation.

Given the short nature of this essay, I decided to take an “issue-spotting” approach and present my views about three strengths of the Decker-Yarrow Paper and three areas in which the Decker-Yarrow Paper would have benefitted from further development, discussion or clarification.

### **Strengths of the Decker-Yarrow Paper**

Although this point may be obvious, I begin by applauding the authors for their clear and accessible review of the regulatory reform literature. In my view, one of the primary purposes of this Decker-Yarrow Paper should be to encourage interdisciplinary discussions and debate about the important topic of lawyer regulation. In order for this dialogue to be meaningful, it is important that everyone participating in the discussion has a shared understanding of the key principles in all of the relevant fields. From my perspective, the Decker-Yarrow Paper did an excellent job of presenting the economic and regulatory reform literature. The Decker-Yarrow Paper provides useful background information to those who are not very familiar with the regulatory reform area (especially utility reform) and helps them understand the economic/regulatory reform vocabulary and frame of reference.

The second commendable aspect of the Decker-Yarrow Paper is its broad definition of the phrase “economic rationale” especially since its definition included factors that some might view as “non-economic” factors. The Paper’s reasoning, however, was persuasive. Moreover, its definition seemed particularly sensible given the nature of the discussions and debates among legal profession scholars and the Legal Services Board’s goal of stimulating an interdisciplinary conversation about legal profession regulation. To ignore these factors would contribute to a more one-sided and less meaningful discussion and exploration of the issues.

In developing its definition of economic rationale factors, the Decker-Yarrow Paper began by observing that economic theory typically divides policy issues into concerns of efficiency and of equity and that many policy debates concern the tradeoffs between these two issues. (15). The Decker-Yarrow Paper explained that economists typically focus on the efficiency concerns rather than the equity concerns because they “cannot lay claim to any great expertise” with respect to the latter (23). The Decker-Yarrow Paper continued by noting that

economic research that focuses on third-party effects (or externalities) might support a role for regulation in terms of addressing issues of equity and fairness, but that these issues might also be viewed as raising “efficiency” concerns. It pointed out, for example, that lack of access to the legal system could lead to detrimental economic (and social) effects because concerns about the legitimacy of the legal system could reduce the willingness of parties to participate in the system, which in turn might cause harmful effects on economic/social welfare. The Decker-Yarrow Paper argued that these ‘participation effects’ are economic efficiency issues. It framed the “legitimacy” and “quality” arguments in this fashion:

Reduction in participation in a market which is consequential on a lack of legitimacy of, or lack of confidence in, market institutions is, very obviously, an economic effect – the level of market activity is lower in consequence – and can potentially give rise to an ‘economic rationale’ for regulation. Such legitimacy/confidence is, for example, potentially very significant in international capital markets, since investors will, for obvious reasons, tend to avoid markets where there is a prospect that, having committed substantial resources, they will not subsequently be treated fairly in the event, say, of disputes. In what follows, we will consider these legitimacy/confidence effects in the context of potential uncertainties about the ‘quality’ of legal services, since certain aspects of equity and fair dealing can be viewed, from the consumer perspective, as aspects of a broadly defined notion of ‘quality of service’. It is to be remembered, therefore, that, in the later material, ‘quality’ is used in this very broad way, and can potentially encompass a range of different factors. (24)

Since some of the prior economic literature on the legal profession arguably fails to take into account the effect of proposals on public confidence in the integrity of the legal system and the “rule of law,” the approach used in the Decker-Yarrow Paper was particularly welcome. It is important for the economic and regulatory reform experts to address the “legitimacy” and “quality” issues that legal profession scholars raise and that were encompassed within the “efficiency” framework used in the Paper.

A third commendable aspect is the Decker-Yarrow Paper’s inclusion of the “repeat player” concept when concluding that “rationales for regulation may differ as between different types of consumers.” (27) In my experience, many lawyers and lawyer regulators are sceptical of the claim that “sophisticated” clients should be regulated differently than “unsophisticated” clients; they cite the difficulty of defining this term and the fact that because of the information asymmetry discussed elsewhere in the Decker-Yarrow Paper (28), individuals and entities who are sophisticated in a business context may not necessarily be sophisticated with respect to their legal needs. Given this scepticism about whether one can define “sophisticated clients,” it was useful to have the Decker-Yarrow Paper combine these two concepts when discussing the concept of differentiated regulation: “Large, well informed commercial organisations **that buy legal services on a frequent basis** may be very well informed indeed, and may even be able to exert a degree of buyer power.”(27)(Emphasis added).

In sum, the Paper did an excellent job of laying the groundwork for future discussions and debates about lawyer regulation. The three examples offered above exemplify the types of

analysis that will press the debate forward, although they were by no means the only points that were commendable and that are likely to prompt thoughtful discussion and debate.

### **Critiques of the Decker-Yarrow Paper**

As noted above, my overall impression of the Decker-Yarrow Paper was exceedingly positive. This Paper should serve as a useful bridge between the legal services experts and literature and the regulatory reform and economic experts and literature. Thus, the critiques and suggestions that follow should be read in the context of the overall positive tone in this essay. In the section that follows, however, I identify three specific points at which the Paper could have been more consistent, contained more analysis, or probed more deeply.

#### **Be More Consistent in Reminding the Reader that Legitimacy and Quality Concerns May Require One to Look Beyond the Impact of Regulation on a Specific Client**

My first critique is closely related to one of the strengths of the Decker-Yarrow Paper that I identified. As noted above, one of the strengths of the Paper was its inclusion of “legitimacy” and “quality” as factors that properly could be considered under an “efficiency” economic rationale. On a few occasions, however, the Decker-Yarrow Paper used narrow “bilateral” language that might allow the reader to “forget” about the broader economic rationale concerns. An example of this “bilateral” language is found in the section that addressed the structure of regulation where the Decker-Yarrow Paper states:

In the discussion so far we have noted that, generally speaking, the economic rationale for some form of regulatory oversight of the legal profession is premised on the need to maintain quality, and to address an information asymmetry between consumers of legal services and suppliers. In addition, regulation may be premised on the need to provide access to affordable legal services, and ***to ensure that consumers are not exploited where they are in a position of significant weakness relative to suppliers. (Emphasis added)***(59)

If taken out of context, this language might be used to support the view that so long as **a specific consumer** is protected in a **specific transaction**, regulation is unnecessary and one need not worry about the larger “legitimacy” or “quality” issues. Because legitimacy and “rule of law” issues are integral to lawyer regulation (and, in this respect, lawyer regulation is different than many other types of regulation), it would have been more effective if the Decker-Yarrow Paper had consistently used language that reminded readers of the broad economic rationale framework set forth previously. Use of the word “consumers” without a reference to the broader issues, such as system legitimacy, might be interpreted to mean that **individual** consumer/client protection is the primary concern of regulation and that so long as the client is able to protect itself, regulation is unnecessary. This is a view that the UK has already rejected as demonstrated by the breadth of factors included in the “regulatory objectives” found in Section 1 of the 2007 Legal Services Act. This rejection was proper and desirable because there are legitimate systemic issues, as well as individual

client protection issues, of which regulation should take note. To fail to do so can lead to system failures such as those we saw in the U.S. in the Enron debacle and some of the recent global financial crisis problems.

### **The Need for an Assessment Framework**

Second, the Decker-Yarrow Paper would have been stronger if it had developed in greater detail the “assessment framework” idea that it introduced. The Decker-Yarrow Paper asserts that some form of “assessment framework needs to be developed which allows for specific rules, or groupings of rules, to be identified and then assessed in terms of their likely impact on competition and consumers, and on other regulatory objectives (including non-economic objectives).”(66). I could not agree more.

Because of the importance of this issue and the paucity of existing guidance, it would have been very helpful if this section of the Decker-Yarrow Paper had provided practical guidance to those who must develop an assessment framework. This issue is an exceedingly important one and this section of the Decker-Yarrow Paper was worthy of much more attention and development.<sup>10</sup> From the perspective of regulators, this aspect of the Decker-Yarrow Paper is one of its most important since they will have to determine how to turn the lessons of the Decker-Yarrow Paper into a process and then into specific regulations. A second reason why it would have been useful to get more guidance on the assessment framework issue is because those who are not steeped in the regulatory reform literature might wonder question whether there is a fundamental tension between some of the positions advocated in the Decker-Yarrow Paper and various global regulatory reform initiatives. For example, on the one hand, some of the ideas included within the paper’s “economic rationale” clearly will be difficult to measure, especially *ex ante*. On the other hand, some global regulatory reform efforts, such as those of the OECD for example, would have governments “design economic regulations in all sectors to stimulate competition and efficiency, and eliminate them **except where clear evidence demonstrates that they are the best way to serve broad public interests.**” (Emphasis added).<sup>11</sup> Neither the OECD’s *Guiding Principles* nor the accompanying commentary explain what is meant by the term “clear evidence” or how one might apply that principle in contexts where the concerns (e.g., the impact of certain regulations on the public confidence or the rule of law) do not lend themselves to easy measurement. While it is easy to imagine how one might measure whether there is “clear evidence” that a particular environmental chemical causes health problems, it is much more difficult to imagine how one might measure whether a change in regulatory structure will negatively influence efficiency factors such as public confidence in the legal system, the robustness of the rule of law, or the quality of legal services. Thus, one might wonder whether there is a fundamental tension that needs to be resolved between a detailed assessment framework approach that the Decker-Yarrow Paper might have put forward and the OECD’s “Guiding Principles for Regulatory Quality and Performance.” It would have been useful if the Paper had embraced the opportunity to provide more concrete

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<sup>10</sup> In defense of the Paper, one might argue that it was beyond the scope of the Decker-Yarrow Paper to provide an assessment framework and therefore this criticism is misplaced. To regulators, however, this will be one of the most important aspects of the paper.

<sup>11</sup> Organization of Economic Cooperation and Development (OECD), *Guiding Principles for Regulatory Quality and Performance* (2005), <http://www.oecd.org/dataoecd/19/51/37318586.pdf>.

details about how regulators should go about the difficult task of developing the recommended assessment framework.

The Decker-Yarrow Paper got close to tackling the “assessment framework” issue when it discussed organizational structure regulations, stating:

Restrictions on forms of business organisation may, therefore, be justified when they are a response to some clearly defined problem, but a general scepticism is in order, **and the burden of proof should be with those claiming a restriction is desirable.** This appears to be the broad approach taken by the European Court of Justice, and it follows from what we have said that there is no significant divergence between the Court’s approach and the general implications of the relevant economic and social science literatures. (56) #

At the end of the day, however, it will not be enough to simply say that the “burden of proof” rests with those claiming a restriction. Regulators and decision-makers ultimately will have to decide how much proof is enough to carry this burden of proof and what can of proof is required.<sup>12</sup> The quote cited above provides a concrete example of a situation in which the Decker-Yarrow Paper could have, but didn’t, provide concrete details about how, in the legal services context, one should go about the difficult task of developing an assessment framework to answer difficult regulatory questions, particularly if the risks do not lend themselves to easy measurement.

### Defining “Self Regulation” and its Alternatives

Third, the Decker-Yarrow Paper’s treatment of the concept of “self-regulation” failed to unpack the concept adequately. The Decker-Yarrow Paper seems to implicitly use a definition of self-regulation that is similar to the UK’s prior model of self-regulation by a “representational” body. While this is understandable since the Paper was commissioned by the UK Legal Services Board, the Paper would have been stronger if it had had a more in-depth discussion of the meaning of self-regulation and had probed the issue of whether the “risks” of self-regulation are the same under different models of self-regulation.

Although the Decker-Yarrow Paper does not make this point explicitly, its discussion of self-regulation’s risks and benefits suggests that when it speaks of self-regulation, it has in mind regulation by “self-regulating professional organisations” under the control of practicing lawyers whose personal financial interests may conflict with the interests of their clients and others. In other words, it seems to envision a system of self-regulation by what has been called “representational bodies” as opposed to “regulatory bodies.” If this is correct, then this definition of self-regulation inherently involves self-interest and a profit motive that could conflict with the client’s interest or public interest – *i.e.*, the moral hazard is unavoidable. Perhaps not surprisingly, then, the “alternative” regulatory structures the Paper considered

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<sup>12</sup> See, e.g., Laurel S. Terry, *MDPs, “Spinning,” and Wouters v. Nova*, 52 Case Western Law R. 867 (2002) (suggesting that other courts might be much less inclined than was the Wouters court to find that the Bar had carried its “burden of proof” with respect to its MDP regulations).

(62) involved removing the self-interested professionals from regulation entirely or adopting a hybrid solution (62) that would dampen the professional organization's powers by subjecting self-regulation to oversight by another entity or by diluting the potential conflict of interest by adding lay involvement or oversight by a consumer watchdog.

While this analysis was useful, the Paper would have been stronger if it had considered other models of "self-regulation." (This would also increase the usefulness of the Decker-Yarrow Paper for those located outside the UK.) For example, what if self-regulation takes place under the auspices of regulatory bodies [of lawyers] rather than representational bodies that are answerable to lawyers with a profit motive? Canada, for example, has "regulatory" bodies that are separate and distinct from its legal profession "representational" bodies. These regulatory bodies are staffed by full-time lawyers who do not represent clients and who do not have a profit motive. Should this still be considered to be "self-regulation?" If so, does this type of "self-regulation" face the same risks as those discussed in the Decker-Yarrow Paper?

In the U.S., lawyer rules are adopted by state Supreme Courts. The Courts are comprised of lawyers, but these lawyers do not engage in private practice and do not have the same type of personal profit motive as a representational professional organization does. Furthermore, as a result of the influential Clark Report,<sup>13</sup> which heavily criticized the conflicts of interest inherent in the prior lawyer discipline system, U.S. lawyer discipline prosecutions are typically handled by offices that are staffed by full-time lawyers whose only job is prosecuting lawyers, who do not have a private practice, and who are answerable to the Supreme Courts and not to the representational professional organizations. Is this "self-regulation?" If so, does this type of "self-regulation" face the same risks as those discussed in the Decker-Yarrow Paper?

As I thought about these two examples, I found myself wondering whether eliminating the profit motive and imposing full time professional status requirements might be alternative regulatory structures worth considering. Would these alternatives accomplish the same thing or different things than the alternative of changing the identity of the regulator from lawyer to nonlawyer?

These are important questions to consider because a number of legal profession experts believe that for rule of law purposes, it is important for the legal profession to remain independent and the bulwark against governmental abuses of power. While the Decker-Yarrow Paper accurately observed that there are "differing views regarding the distinctiveness of legal services relative to other professional services" (3), I suspect that there would not be differing views about the economic and social importance of maintaining a robust rule of law. Thus, in my mind, some of the most important unanswered questions are:

1) whether there is a relationship between the independence of the legal profession and the robustness of a society's rule of law;

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<sup>13</sup> ABA Report of the Commission on Evaluation of Disciplinary Enforcement (1992), [http://www.americanbar.org/groups/professional\\_responsibility/resources/report\\_archive/mckay\\_report.html](http://www.americanbar.org/groups/professional_responsibility/resources/report_archive/mckay_report.html).

2) whether the legal profession's regulatory structure affects the independence of the legal profession; and

3) whether regulation by other branches of government or by those outside the legal profession tends to make the legal profession less independent.

These are important questions. Because we do not yet know the answers to these questions, it would have been useful to have had the benefit of the authors' analysis of the efficacy of alternative regulatory structures that focused on removing the profit motive/rent-seeking motive of the lawyer-regulators, while vesting primary control for lawyer regulation with the legal profession. For these reasons, the Decker-Yarrow Paper would have been stronger if it had included an analysis of alternative models of self-regulation, including regulation conducted by full-time, professional, regulatory bodies, rather than representational professional organizations answerable to its members.

## **Conclusion**

This very brief essay has highlighted three aspects of the Decker-Yarrow Paper that are particularly strong and three areas in which the Paper might have benefited from an expanded discussion. As my introductory comments have noted, however, my overarching comment is that this Decker-Yarrow Paper is an important contribution to the literature and can provide the basis for useful interdisciplinary discussions among all of the stakeholders who are interested in regulatory issues related to the legal profession. I commend the Legal Services Board for commissioning this Decker-Yarrow Paper and the authors for their thoughtful analysis.

## Calibrating Regulation

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The Legal Services Board is not short of jobs to do. Under the Legal Services Act 2007 it has no less than eight objectives: protecting and promoting the public interest; supporting the constitutional principle of the rule of law; improving access to justice; protecting and promoting the interests of consumers; promoting competition in the provision of non reserved legal services; encouraging an independent, strong, diverse and effective legal profession; increasing public understanding of the citizen's legal rights and duties; and promoting and maintaining adherence to the professional principles. The LSB is thus in part a market-perfecting regulator, in part an educator, in part a supporter of the profession, and in part a 'rights' regulator.

The Decker and Yarrow report<sup>14</sup> focuses on part of that role – the LSB as a market-perfecting regulator. It identifies the main market failures that can arise in the provision of legal services. Economic analyses of this nature are a feature of many regulatory landscapes, and the Decker and Yarrow report offers a familiar analysis. The report observes that the market is characterised by significant information asymmetries, exacerbated by the nature of the services provided, namely the provision of expert advice, which renders it difficult for consumers to assess the quality of the advice being given (though they can assess ancillary aspects of that service, such as promptness in responding to letters, whether the costs of the service are made clear, and so on). In addition, the role of the professions as regulators raises the risk that the rules that the profession creates to regulate its members will act as unwarranted barriers to entry and will generally be in the interests of the profession rather than the consumer.

Successive reviews of competition in the legal services market and into self regulation have come to similar conclusions, including those by the Office of Fair Trading and the Clementi Report, the latter of which was the basis of for the 2007 Act and the creation of the Legal Services Board.<sup>15</sup> The LSB was established to regulate the professional bodies to ensure that they did not abuse the privilege they enjoy from the state as the recognised regulators of the legal professions. Indeed the Act aims to facilitate a market in regulation as well as one in legal services by allowing other regulatory bodies to be created, subject to its approval.

The legal services market, however, is more complicated than the report suggests. Certain activities are not open to competition from outside the profession, they are reserved by statute for solicitors or barristers, though as report from the Legal Services Institute makes clear, the list of reservations is a result of deals done and concessions made long ago; it has

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<sup>14</sup> C. Decker and G. Yarrow, *Understanding the Economic Rationale for Legal Services Regulation* (Legal Services Board, 2010).

<sup>15</sup> London Economics Consulting Group, *Restrictions on Competition in the Provision of Professional Services A Report for the Office of Fair Trading* (OFT 2000); OFT, *Competition in the Professions A Report by the Director General of Fair Trading* (OFT, 2001); D. Clementi, *Review of the Regulatory Framework for the Provision of Legal Services in England and Wales* (Ministry of Justice, 2004); OFT, *The economics of self-regulation in solving consumer quality issues*, OFT Economic Discussion Paper 1059 (OFT 2009).

little or no substantive set of rationales underlying it.<sup>16</sup> However, there are multiple providers of these activities, and the OFT inquiry, for example, found no evidence of cartel behaviour. The nature of the services being provided is also very variable. Some legal services consist of relatively straightforward, routine activities which can be standardised, performed by those with only basic legal knowledge, and / or out-sourced. Conveyancing is a familiar example but out-sourcing of routine processing activities by the large City firms, such as document review and discovery in complex litigation, research in patent applications and contracts review as part of due diligence exercises has grown in recent years, particularly to India.<sup>17</sup> Other activities, such as the provision of legal advice in complex situations, are bespoke and require a high level of knowledge and expertise. Consumers of legal services are also very different. The in-house lawyer in a multinational seeking advice on financing the construction of a large infrastructure project may be consuming more complex legal services than the welder seeking to bring a case for unfair dismissal, or the speech therapist seeking to bring a claim for indirect discrimination, but the former is far more able to assess the quality of the service they are receiving than the latter. These complexities could be captured in a more fine grained analysis of the market for legal services, and it may be that future reports will look more closely at the different sub-markets and the types of providers and consumers that participate in them.

The report instead operates at the level of broad principles, as it was asked to. One of the advantages of economic analysis is its ability to pare down complexities, and to render all markets homogenous. In such a way, regulating legal services can be compared to regulating any other market, such as telecommunications. All markets are treated as identical, no matter whether what is being traded is use of a mobile phone or legal advice. Moreover, the 'diagnosis-prescription-cure' model of economic analysis is very comforting for regulators. Diagnose the market failure, prescribe the appropriate remedy, and the cure will follow. Is the diagnosis information asymmetry? Not to worry – we can fix that by requiring disclosure. Is it credence goods? No problem - we can remedy that by requiring quality controls such as a minimum standard of training. Is it monopoly rents? Not to fear – we can either regulate prices or open up the market to competition. Externalities? We can introduce 'producer pays' regulation. And so on.

There is nothing wrong with such an approach in itself. Economic analysis can be a powerful tool which can help regulators analyse a problem and tell them how to fix it. However, the goals of regulators are not always to fix markets. There can be other goals. Much of risk regulation is not about market failures, for example. Although it can sometimes be characterised in such terms, much of the essence of what risk regulation is trying to achieve is then lost. An explosion in a nuclear power plant or an outbreak of salmonella can be characterised in economic terms as externalities. However that characterisation does not really get at the heart of the issues nor does the standard set of regulatory prescriptions from the market failure model really help resolve them. Instead, regulation here speaks a different language: that of risk, and the resolutions are to be found in systems to ensure

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<sup>16</sup> Legal Services Institute, *The Regulation of Legal Services: Reserved Legal Activities - History and Rationale, A Strategic Discussion Paper* (Legal Services Institute, 2010).

<sup>17</sup> See eg J. Dean, 'How legal process outsourcing is changing the legal landscape', *Law Gazette*, 25 February 2010; S. Denyer, 'Legal outsourcing remains high on the agenda', *The Times online*, 9 September 2008.

precaution, resilience, reversibility or clean up. Regulation can also be directed at other goals, as in the case of the regulation of legal services.<sup>18</sup>

The difficulty for regulators of pursuing goals other than that of remedying market failures is that other goals often do not lend themselves so easily to the ‘diagnosis – prescription – cure’ decision model of market-perfecting regulation. Everyone might agree on the broad definition of a market, even if they may differ on the finer details of how it should be defined for the purposes of assessing competition, or may disagree as to what governments’ relationship to it is or should be. Far fewer people are likely to agree on what constitutes a ‘risk’, let alone what might be considered the ‘public interest’. Diagnosing when there is a risk, for example, is often highly contested, particularly in cases of uncertainty (for example, do GMOs pose risks?). If the problem is contested then the prescription is bound to be unclear (should regulators presume they do unless it is clear that they do not – the precautionary principle; or assume they don’t unless it is clear that they do?). Even when the diagnosis is agreed (for example, high fat diets lead to health risks) the prescriptions can be contested (should regulators set limits prescribing the maximum permitted levels of certain products in processed foods or should they rely on labelling and consumer education?) The same is true for other problems and other goals, not least the first three of those specified in the Legal Services Act: promoting the public interest, supporting the constitutional principle of the rule of law and improving access to justice.

In the face of such open and uncertain goals, it is not surprising that regulators fall back on the comforting familiarity of the ‘diagnosis – prescription – cure’ model of economic analysis. It is an idealised, abstracted model of decision making which in practice rarely matches up to political or regulatory reality. Nonetheless, it provides regulators with a clear justification for regulation and a route-map for what to do. Consequently the goal of market-correction can end up trumping other goals, or (perhaps more frequently) those goals end up being defined as derivative on the attainment of the principal, market-correcting goal. It is much easier to argue that the attainment of the goals of the public interest or access to justice can be derived from promoting consumers’ interests and ensuring a competitive market in legal services than to try to identify what access to justice or the public interest might require quite separately from an efficient market.

Should we then argue that economic analysis has no place in regulatory decision making? Not at all. Correcting market failures may well be an appropriate goal. Regulators can stray from their remit, however, if it becomes the only goal. We all know that trade-offs have to be made. Economic goals have to be balanced with other goals, albeit reluctantly, perhaps. But, as noted, economics has more than ideology on its side. It has a method. One of the reasons it can become the only, or at least dominant goal, is not necessarily ideology, but practicality. Economic analysis offers a decision making model which is beguiling for regulators in its both in its conceptual simplicity and its systematic methodology. It provides them with an analytical framework to identify a set of problems, a set of tools to address them and a guide for using them, together with a ready set of justifications to offer to regulatees, politicians and the public. What more could a regulator want?

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<sup>18</sup> For a thorough, recent discussion see Legal Services Institute, *Legal Services Regulation – What is the Case for Reservation, Interim Strategic Discussion Paper*, (Legal Services Institute, 2011).

In contrast, objectives such as the public interest, the rule of law and access to justice are ill-defined, contestable, and come unaccompanied by any clear or systematic methodologies on which regulators can draw to make decisions about when to regulate, how to regulate, and how much to regulate. Unless such a methodology can be found, economics will often triumph. Until we can find a systematic way to define goals such as 'access to justice' or maintenance of the 'rule of law', and provide a method by which regulators can make decisions about how to pursue those goals, then these goals will remain vague, ill-defined and, consequentially, un-operationalised. In their sheer 'fluffiness' they will pose no opposition to the relentless logic of economic analysis.

What, then, can be done? If we want regulators to pursue other goals, the trick is to render those other goals more tractable. A first step could be to look to other regulators to learn from, not just economic regulators, and other ways to analyse problems, not just economic ones. Risk regulators, for example, face a more complex task in many ways than economic regulators, and employ a number of different decision principles to stabilize decisions about risk using versions of a 'diagnosis – prescription – cure' model. These comprise principles of scientific analysis (diagnosis) and decision principles for determining what action to take (prescription). In this latter category include the precautionary principle (assume it is risky until proved safe), the principle of resilience (assume you cannot prevent risks occurring so focus on being able to minimise their impact when they do), and variations on the theme of cost-benefit analysis (only regulate to the point that the costs of regulation equate to the benefits).

The difference between an economic regulator and a risk regulator is that for the latter, the diagnosis and the prescriptions are often far more contested than they are for the former. Furthermore, the goal that risk regulators are seeking to attain may in some circumstances be undesirable. We can never eliminate all risks, and even if we could the social cost of doing so can be simply too great. I can eliminate the risk of dying in a traffic accident by never using the roads – but this is hardly a practical way to live and the aggregate social cost if all took the same course of action would be too great (though the now empty roads would become very safe). So not only is the goal of absolute safety often unattainable, it may also be undesirable.

Risk regulators are therefore called on to calibrate regulation, in their case, to determine how safe is safe enough. But herein lies a further difference between risk regulation and market-perfecting regulation. How 'safe' something should be is recognised as ultimately a social / political question with a social / political answer, though technocratic analysis can still dominate in practice. How 'perfect' a market should be is largely seen as a technical question with a technical answer.

Risk regulators are here in a similar position to rights regulators. We are not used to thinking in terms of 'rights' regulators, but this is largely because of the traditional way decisions about rights have been distributed between the institutions of the state: courts traditionally determine rights, not regulatory agencies. But some regulators are charged with regulating rights or securing the pre-conditions for their exercise, such as rights to non-discrimination, and in the LSB's case, rights of access to justice.

The LSB could learn from risk regulators and rights regulators as much as it could from economic regulators. Rights regulators, like risk regulators, operate in a context of

contestability. Identifying what is a right is as socially and culturally contested, if not more so, than identifying what is a risk. Which rights should be selected for political attention is as contested, if not more, than which risks should be. How far a right should be protected is as contested, if not more, than how far a risk should be eliminated or at least mitigated. Both risk regulators and rights regulators have to calibrate their regulation: the goal of protection of rights has to be balanced with the need to ensure that the protection of one right, or the right of one person, does not jeopardise the attainment of another right, or the use by others of that same right, just as the goal of safety has to be balanced with the need to ensure that in eliminating one risk we do not thereby create other risks, or shift that risk onto others.

All regulators have to develop methods to calibrate regulation. Calibrating regulation is a difficult task: often the decision regulators face is not whether to regulate but how much to regulate. How to calibrate regulation means more than how to perform a cost-benefit analysis. It means recognising that regulation is inherently a balancing act, and there are some decisions which cannot be reduced to equations. But it does not mean that regulators have to 'fly blind' – that there can be no systematic basis for decision making. As argued above, what regulators seek when they turn to economic analysis is not necessarily the ideology of neo-liberalism; rather it is its ordered, methodical rationality. It is for this same reason that they are turning to risk-based regulation as a decision making mechanism to calibrate where they should focus their regulatory resources. The question being asked by risk-based regulators is: 'what are the risks posed to our objectives – *all* our objectives? The method is perhaps not always a sophisticated one, but it does at least require a systematic analysis of what all those objectives are, what the risks are that those objectives might not be achieved, and how those risks need to be addressed.

Economic analysis can provide a similar systematic methodology, but when regulators turn to economic analysis to provide an ordered system of decision making, it is the goals of economics and its way of viewing the world which dominate. If their regulatory objectives are solely economic, that is appropriate. Where they are not, then a broader approach is required. The objectives of the LSB are far wider than economics, and deserve a more thorough consideration. They then need to be rendered tractable and, in management terms, operational. As a method, risk based regulation has its limitations, but perhaps it is time that regulators should start using it more systematically not just to allocate inspection resources, but to help them analyse what the problems are they are trying to resolve and how to calibrate regulation to address them. Being a rights regulator as well as market-perfecting regulator, and an educator and profession-supporter, is not easy, but finding a systematic method to analyse and address all the LSB's objectives is necessary if the inevitable trade-offs are to be appropriately made.

## **Why there might be a market for lemons: Some thoughts on competition, quality and regulation in legal service markets**

**Professor Richard Moorhead**

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Decker and Yarrow's report ("the Report") speaks to three issues key to understanding the Legal Service Board's approach to regulating legal service markets: competition; independence of regulatory judgment; and, the importance of empirical evidence to support those judgments. The report emphasizes a number of presumptions in considering those issues which also fit well with the LSB's direction of travel. It suggests:

- in the absence of evidence to the contrary, competition is a better public policy tool than restrictive practice;
- restrictive practices reduce price competition, inhibit innovation and may dampen potential improvements in quality;
- even where regulation is justified it should be proportionate and risk-based; and,
- there is a need for scepticism of the mechanisms and rules of self-regulation, whilst acknowledging the benefits that self-regulation may also bring.

Furthermore, the Report sensibly suggests that regulatory dilemmas should not be posed in absolute terms. In particular, theoretical risks based on economic models with assumptions which bear no relation to reality should be treated with caution. Instead, a context specific, institutional economic approach should look at what can be realistically done to deal with regulatory problems. This approach should be evidence based (and perhaps incremental<sup>19</sup>) in nature. Regulation should be proportionate and pragmatic not dogmatic and ideological.

Whilst careful to balance its messages, in important respects the report leans back on two related assumptions. One is that competition for legal services is unlikely to lead to a race to the bottom (or a 'market for lemons'). That is, it argues increased competition for legal services is not likely to lead to quality being undercut to dangerously low levels. The second is that in principle self-regulatory approaches are likely to drive up quality beyond what is necessary rendering legal services less affordable and so posing access to justice problems. Indeed, in considering "market for lemons problem" they indicate, "a market for gold plate is more likely".<sup>20</sup> Competition under conditions of self-regulation will drive quality too high. Against this background, the LSB's priority would be to ensure legal services become more affordable (and so accessible), whilst ensuring consumer confidence in the quality of legal services. In public policy terms, the idea is win-win: consumer trust and affordability can both increase the size of legal service markets. It is also reasonably clear in its trajectory, being deregulatory in approach: the case for regulation has to be made with evidence not the other way round.

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<sup>19</sup> The paper does not state that an approach should be incremental but it seems to me this fits with the overall direction of the authors.

<sup>20</sup> Pages 31 and 32 of the Report.

In what follows, I challenge the *strength* of this presumption in favour of competition. I take it as read that competition has benefits, but I believe the Report under-estimates the risks posed to quality. In particular, I aim to advance a debate about how we might sponsor the *right kinds* of competition in legal services. To do this, I look at some of the evidence on competition in health services. The central idea is that regulators need to be sure that the markets they govern stimulate competition on quality rather than just price.

### **What the health economics literature says about competition**

In so far as Decker and Yarrow tend to dwell on specific elements on the economic literature, they rely on utilities regulation. For me, it is a surprising choice. Given the asymmetries of information between supplier, patient (and purchaser) and the involvement of (powerful) medical professions, there are some important analogues with legal services: health economics might provide more interesting insights. It is also an area where there is an emerging empirical literature on the relationship between competition, price and quality.<sup>21</sup>

This empirical work tends to examine competition either in the NHS in England and Wales and in the United States. It looks at competition on price; competition on quality; and competition on both quality and price. The findings from this research tend to suggest that competition on price alone diminishes quality. In social welfare terms that is not necessarily bad: prices and quality may be higher than the client needs: the dentists' smile may be expensive and beautiful but if it is not affordable or necessary then lower quality dental services may be justified. It is also important to note that whether a diminution in quality is good or bad depends on the appropriateness of the price. If price is too low, then quality can diminish to unacceptable standards: a market for lemons *can* develop. In health services, competition on price alone can kill.

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<sup>21</sup> See, for example, M. Gaynor (2006) 'What Do We Know About Competition and Quality in Health Care Markets?'; [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=910834](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=910834); Z. Cooper et al (2010) 'Does Hospital Competition Save Lives? Evidence from the English NHS Patient Choice Reforms', LSE Health Working Paper No 16. London; C. Propper (2010) 'Healthcare Competition Saves Lives', <http://www.bristol.ac.uk/cmpo/publications/bulletin/winter10/propper.pdf>

Conversely, the research suggests that competition on quality alone *increases* quality. This is heartening but unsurprising. Suppliers who have no other means of competing, do so on quality and raise their observable quality to attract more clients. Their ability to do this depends on their ability to signal meaningfully higher levels of quality.

The research on competition where there is quality and price competition is more mixed. It suggests that competition reduces price, but quality appears to have been reduced sometimes and increased in others. The most likely way of explaining this difference in results is whether consumers know about and respond to *differences in quality*. That is, for competition to occur successfully on the basis of quality consumers have to perceive real differences in quality and perceive that those differences in quality are worth paying for. Put another way, for quality to improve under price and quality competition, signals of differences in quality have to be of comparable strength to differences in price. Critically, competition on quality is dependent on consumers knowing about *and responding to differences* in quality. In health services such competition has typically occurred because the purchasers were informed, volume purchasers such as insurers, GPs or primary care trusts (PCTs).

Where does this leave us in relation to legal services? The most important thing that this suggests is that for a market for legal services to function effectively signals about the relative quality of legal services have to be at least as meaningful as signals on price. If they are not quality is likely to diminish significantly as a result of competition. That is not to say consumers cannot, or should not, choose price over quality, but that they should do so on a reasonably informed basis (as long as signalling quality in this way can be done on a proportionate basis).

Most of the research on consumers of legal service suggests that would-be clients assume that all lawyers are equally competent, although I suspect also – based partly on my own work – that clients have some inchoate ideas about relative quality<sup>22</sup> (some use specialisation and price ('you get what you pay for') as proxies). Ensuring that stronger signals of relative quality develop within legal service markets should be a central goal of professional service providers and professional regulators. Whether we should let the market work this out for itself or the regulators should step in first is an interesting question which may vary depending on the risks posed in particular markets and the costs of intervention.

The market can be seen to be responding to the quality issue through evolving markets for intermediaries. Referral sites pass on clients (e.g. Wigster.com) and franchise operations (e.g. QualitySolicitors) assure their customers that they are referring them onto firms who's quality is monitored. The extent of such quality assurance can, on publicly available evidence at least, best be described as modest. Limited service standards deal with things like the time to be taken to respond to telephone queries. For some, at least, there is a degree of monitoring of consumer satisfaction. To the extent that legal services are 'experience goods' where consumers "becomes aware of the quality as it is being consumed"<sup>23</sup>, monitoring (if conducted well) may usefully aggregate consumer judgments on quality that are nevertheless somewhat imperfect. We simply do not know how important

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<sup>22</sup> See, Moorhead and Cumming (2010) *Something for Nothing* : Employment Tribunal claimants' perspectives on legal funding (London: BIS).

<sup>23</sup> Report, Page 31

those imperfections are, though we do know consumer satisfaction can mask professional incompetence.<sup>24</sup> There are some claims that the reputation of firms is subject to scrutiny before being admitted to at least one of these arrangements.<sup>25</sup> Again, the nature and efficacy of these reputational tests are unknown. It is reasonably clear that the notions of quality being utilized so far are heavily service oriented: they concentrate on aggregating and ensuring the service issues that clients can evaluate themselves. They are epitomised in the friendly faces (interestingly, animated rather than real) used to market the services in adverts and websites. The benefits of aggregation are not to be sniffed at, but the question is whether such mechanisms will be sufficient protection of quality if competition pushes down on technical elements of quality which clients (and intermediaries) are not in a position to judge.

It should also be emphasised that there are differences between the legal services sector and the health sector. Barriers to entry are different (especially at the specialist end given the infrastructure hospitals require) and the role of public finance is stronger: in legal services the dominant model is clients purchasing for themselves; in health it is third parties purchasing for clients (be they insurers/HMOs, GPs or PCTs). The existence of divisions of labour in a system may aid purchasing decisions and the process of competition. Competition on quality works when purchasers understand and value quality appropriately with reference to cost. Hence the assumption that GPs (or PCTs) might make a better job of choosing specialist health services than the patients. Whether they do so depends in part on economic and other incentives acting on them of course, including the ability to 'know' and act on quality. The historic divide between the solicitors and barristers is one such division of labour, albeit being eroded by a succession of reforms. Furthermore, the impact of the advocate-litigator division may have relatively limited purchase given the relative rarity with which litigated cases involve substantial advocacy. Claims management companies provide another, more controversial division of labour. The emergence of referrers and franchises discussed above suggests another developing.

It might be expected that *useful* divisions of labour will survive (or evolve) through competition. This was the approach the OFT<sup>26</sup> took to Bar's referral only rule and one which at bottom informs the report.<sup>27</sup> There are some reasons to raise doubts, however. One is the complications posed by the commercialisation of referral decisions within the process either tacitly or formally. Any referrer has a desire to keep their clients happy (enough) but also a need to earn any referral fees they can. This may partly be about satisfying rather than maximising client interests. However, in balancing commercial self-interest and service quality, technical quality might be what is squeezed out.

An equally important consideration is what information can referrers (or clients) use to evaluate the quality of any provider. One might argue that as the market for intermediaries

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<sup>24</sup> Moorhead R, Sherr A and Paterson A (2003) 'What clients know: client perspectives and legal competence,' *International Journal of the Legal Profession*, 10 (1) (2003) 5-36.

<sup>25</sup> See, further, Moorhead (2009) 'Branding and Quality: What is Five Star Service?' <http://lawyerwatch.wordpress.com/2010/10/12/branding-and-quality-%E2%80%93-can-a-franchising-model-work/>

<sup>26</sup> Office of Fair Trading (2001) *Competition in professions - A report by the Director General of Fair Trading* (London: OFT).

<sup>27</sup> Report, page 60

matures, so will its approach to quality. Keen to protect their brand, firms will become increasingly choosy about which lawyers they refer business too, or permit into their networks. The risks posed by having technical incompetency exposed might be a salutary incentive to develop better systems of quality control encompassing technical quality. One answer to that might be that the same incentives were operating on the professions but they (arguably) did not respond effectively. Conversely, if such referrers or franchises begin to take significant market share, they will be able to exercise choice over who their 'members' are in a way that professions cannot. Such networks have the potential to be exclusive (and so able to demand higher quality) when professions are under significant political pressure from their members to be inclusive (having to work much harder to justify to their existing members why they should set standards higher). Theoretically then plausible cases can be made that intermediaries may be prone to gold-plating in the way that it is claimed the profession is (if it leads them to more business) or to ignoring technical-quality for reasons of commercial self-interest. In the absence of solid signals of quality the latter is more likely. For me this suggests that regulators need to find ways of understanding and shaping the behaviour of these organizations to maximize the chances that they will base referral decisions on quality rather than purely economic grounds.

A final point is that one defence against a race to the bottom is a strong regulatory floor (i.e. robust basic competence standards properly enforced). Here the important question is whether regulation is both proportionate and strong enough to prevent quality dropping to dangerously low levels. I have been involved in a number of research projects which have looked at the levels of quality provided by practitioners in the legal aid scheme. All of these suggest levels of incompetence which were worryingly low.<sup>28</sup> Why would we think increased competition would make this better unless there is a greater and more imaginative focus on quality in regulation?

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<sup>28</sup> For summaries see, Moorhead R, Sherr A and Paterson A, (2003) 'Contesting Professionalism: Legal Aid and Non lawyers in England and Wales,' Law and Society Review, 37 (4) 765-808 and Moorhead R (2010) 'Lawyer Specialization - Managing the Professional Paradox,' Law & Policy, 33 (2) 226-259.

## **Constructing Contexts: A Response to ‘Understanding the Economic Rationale for Legal Services Regulation’.**

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This is a subtle and nuanced study of the economic rationale for regulation in the legal market. The report is focused as per its remit (p.1) on the economic rationale for regulation of legal services markets and legal services professions. In particular the authors were asked by the LSB to consider why it may be rational in economic terms ‘for consumers of legal services, providers of legal services, regulators, government and society to seek to regulate these services’. The Report therefore explores theoretical bases for regulation of certain types of legal service.

Along with other respondents I have the unenviable task of replying to the Report (made slightly easier by the impossibility of summing it up other than in the words of the Report’s Summary). A disclaimer should be issued before I proceed any further. My field is not economics: I am an educationalist, not an economist, and as such my concerns are primarily with the landscape of legal education, the effects of regulation upon it, and with other issues relevant to it raised by the Report. This may seem to be rather a skewed glance at the Report, which helpfully takes a very broad view of economics and regulation of the legal profession. However it may be a useful approach for a number of reasons. First, legal education is a core regulatory duty of the SRA and the BSB. As such, it is a regulated activity, one that in economic terms is a substantial and complex service industry; one where regulation performs a significant role (which arguably will not lessen but grow in the future), and one where the range and diversity of stakeholders point to a complex field of sometimes competing interests. Second, and as recognised by the Report’s authors, legal education forms part of the entry requirement restrictions to the profession, and can be used to alter supply of services and therefore affect the prices of those services. The issues that arise from this (quite apart from purely economic issues such as monopolization and cartelization), as we shall see, go to the heart of some of the arguments for regulation, and the choice of some forms of regulation over others. Third, legal education is not a special case: the issues that arise in the domain of legal education as a regulated activity do surface in other regulated areas of legal service. Fourth, and perhaps most important, legal education is an example of a regulated activity where the role of economics is insufficiently discussed; where economics plays an undoubted role but where the discussion of that role must take place in a wider cultural, social and educational context.

The last point is critical. As an example, we could consider, alongside the economics of practice and the economics of legal educational provision, the place of moral cultures within both, and the costs of that culture to the profession and to society generally. To adapt E.P. Thompson’s phrase, what we need to examine, as well as the policy & economics angles, is the ‘moral economy’ of legal education and its situation. If so, then what we need to identify

are the moral benchmarks of that community.<sup>29</sup> This effectively means a much more sophisticated approach to the development of both econometrics and ethics.

To their credit the authors are well aware of this. They acknowledge, for instance that 'it is relevant to note that key ideas in the *Wealth of Nations* were first developed in Smith's Lectures on Jurisprudence; that the *Theory of Moral Sentiments* came next, indicating the underlying ethical linkages in the fields of jurisprudence and political economy' (pp.3-4) – they themselves assert that the links between jurisprudence and economics is undeniable. However it is the specific treatment of the link that concerns me in this paper. Access and affordability of legal services is a good example of this. The authors state, rightly, that the issues stem from 'a notion of distributive justice' and, in economic terms, 'merit good' (p.18), where goods or services are provided to those who would otherwise be unable to obtain them because of their cost. They then go on to observe that this is not 'strictly an economic rationale for regulation' (though of course they observe that the working out of the balance between how much of these services would be freely available or priced for users).

I would argue that the principles of access and affordability, in legal education as elsewhere, cannot be separated out from many other issues without a significant reduction of our understanding of them – and that includes, paradoxically, our economic understanding. Intriguingly Decker & Yarrow quote possibly one of the best sources for this argument, namely Scottish enlightenment social, philosophical and economic theory, and particularly Smith.<sup>30</sup> His work is cited in the Report for its economic insights; but as recent work has shown, 'the overall structure of Smith's discourse reproduces the Stoic moral hierarchy' (Brown 1994, 209). Without an understanding of this philosophical context, we are open to misinterpreting Smith and his subtle arguments about the wider discourse of his society – arguments that included comment on access to education and the professions.

Regulation is, as Decker & Yarrow rightly assert, a means by which to address power asymmetries between service suppliers and consumers. They point out that "'ethical" professional regulation can be seen as one way to bring the objectives of the lawyer into closer alignment with those of the customer/client than they otherwise might be' (p.22). However this is an instrumental, disciplinary use of ethical regulation, with serious

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<sup>29</sup> The explicit linking of morality and economics was made by David Edmonds, Chair of the Legal Services Board, in the most recent Lord Upjohn Lecture: 'the strength of the legal profession and the legal services sector relies on precisely that admixture – and I'd argue that the strength of legal education ought to lie in precisely the same mix'. Whether or not one agrees his particular recipe, the general point is well made (Edmonds, 2011). Note, though, that I am *not* espousing the naïve econometric-style 'learning analytics' approach, currently gaining ground, particularly in online learning environments.

<sup>30</sup> They might also have added Francis Hutcheson, not a figure well known in economics circles even in the eighteenth century, one better recognised as an aesthetician and moral philosopher, and for his advocacy of the moral sense as a valid source of human action, and which finds one adaptation in Smith's later work on moral sentiments. Hutcheson taught Smith at Glasgow and, like Hutcheson, Smith held the Chair of Moral Philosophy there. Hutcheson's concept of moral sense does not derive from self-interest (Hobbes); he held it cannot be a mere representation of God's will (Locke), and it was not a self-evident rational truth (Burnet) (Hutcheson, 1971, 19-20). Steering a course between reductionism, religious and rational foundations, Hutcheson's moral sense is ceaselessly at work in human affairs, apprehending, judging, making coherence of the data supplied by senses and reason.

consequences for the regulator. Three points are valid here. First, a regulator who *only* advocated ethical professional regulation for this reason could be accused of self-interested regulation, in that this form of regulation is wholly in the interests of the profession generally (to mitigate the cost of failing lawyers to the profession) and of individual lawyers (this is the best way to manage client expectations regarding services and fees).

Second, is there not a larger duty of the regulator? If, for instance, my client happens to be a government department that instructs me, its legal advisor, to provide a detailed rationale for declaring war on another state, an action which is contrary to international law; or that wishes me to provide a defence of extraordinary rendition of detainees, or water-boarding; and I do so, bringing my 'objectives' into 'closer alignment' with my client, in the language of the Report – am I necessarily any more ethical than if I refuse to carry out my client's instructions on ethical grounds? My example is cited to point up the complexity of the ethical dilemmas faced by lawyers, which, it could be argued, cannot be subsumed under economic rationale alone.

Third, one might go further and question the teleological basis of ethics in this regard, holding that it is better to be transparent regarding the meta-level of ethical value that underlies regulation based on a code of ethics. It may be the case that such a meta-ethics will contradict sound economic, competition, even client-centred principles. These values will in turn affect economic activity in and around the profession. This is not an argument against regulation of course: it is an argument for regulators and their advisors and consultants to recognise the highly complex moral dilemmas that can be faced by lawyers and which are not solvable by economic discourse alone – or indeed by any single disciplinary or professional discourse.

What we require to begin to understand and solve such dilemmas is the equivalent of Peter Galison's 'trading zone', a space where different disciplines and discourses converge on a project, learn versions of each other's discourse and bring their expertise to bear on the difficult and complex issues (Galison 1997). Whether regulation should be advocated, then, in order 'to address issues of fairness and distributive justice' (p.24), it is clear that ethical issues and many other social and cultural issues, not merely 'economic efficiency effects', lie at the core of regulatory decisions on these matters.

This is especially true of legal education as a regulatory concern. Economic analysis most certainly has a place to play here. In the light of the Browne Report, the Comprehensive Spending Review and other recent HE initiatives of our coalition government, there is ever more need for regulatory bodies to bear in mind the economic cost of legal education, and determine whether or not entry to the profession is excessively priced, and whether entry costs impact upon participation by specific socioeconomic sectors of society. One could discuss many issues here, were there space enough. Two will suffice: perfect competition and student choice, and quality and professionalism in legal education.

Perfect competition is described by Decker & Yarrow in the Report. What they say as regards clients is of course true of students as well. But there is a significant difference. Students do not have perfect knowledge of the 'product' i.e. the legal education they are about to enter into, largely because it is not a product but a set of complex processes, extruded through time – a process of change, induction, transformation, where knowledge,

skills, values, attitudes are learned and practised. Thus market price can never tell students all there is to know about education at one or another institution.

A theme of the Report, particularly in s.4, is the economic importance of quality in the market place and the effect that prestige and status has on profit, price and access. This is a notoriously problematic area for education, and many of the methods of discovering quality such as reputation (pp.29-31) have little relevance. Crude scores such as the National Student Survey, though better than no data at all, cannot effectively capture the experiences of studying and living within a university school, any more than the data of 'learner analytics' can even begin to describe the experiences of learning. Instead, all they do is increase the commodification of experience and knowledge.

Other methods of measuring quality are highly problematic. Quality indices are often 'arbitrary, inconsistent and based on convenience measures' while rankings are 'overwhelmingly inadequate attempts to operationalize aspects of excellence' (Harvey 2008, 189; also Harvey 2005). Mathematical models developed on reputational indices have little or no bearing upon a situation that is so multi-factorial as education and, it has to be said, are often little understood by regulatory bodies attempting to implement quality policies (Cheng & Tam 1997). This approach has specific consequences. It is noticeable, for example, how little innovation and creative development of the curriculum of the LPC and the BVC/BPTC has occurred under the close regulation of the curriculum carried by the Law Society and SRA and Bar Standards Board; and in this respect it is interesting that the comments on self-regulation in s.4.3, on pp.36-41 are relevant to legal education supply and control. Self-regulation of legal education that is controlled by the suppliers is undoubtedly open to monopoly and cartelization, and issues of equity, where suppliers could use regulation 'to increase their own incomes above levels necessary to remunerate an efficient supply' (p.38). Regulation is required in this respect. However at present it is probably the case that heavy regulation of curricular matters by regulators serves to create a form of national curriculum that stifles innovation, while encouraging a race to the top of the league table of regulatory appraisals.

Here again, economics plays only a part in the complex culture of designed regulation, policy/audit and its implementation. The current league tables, regulatory appraisals and disciplinary monitoring of curriculum structure and content that is redolent of professional legal education and divides it from undergraduate teaching, could be said to have had a negative effect on the economic activity of educational providers. Educational research has not been valued by regulators as part of the educational activities of professional education centres, and as a result little research-based innovation has prospered. Contrast this with the healthy situation of medical educational research, where research into many different forms of educational intervention has led, in the last half-century, to a rich research literature that has enabled sophisticated forms of multi-disciplinary educational practices to flourish in medical schools. In terms of funding models of course there are many considerable economic differences between law and medicine; and their cultures are wholly different, in that scientific research has always been part of a medical school's *raison d'être*; and therefore it is a short step for medical staff to transfer to medical education the same attitudes and culture pervading their medical practices. Nevertheless, the signal absence of

research in professional legal education in the UK has to be attributed in part to the structure and culture of educational programme models set up by regulators.

Professionalism, for example, is a central issue for any profession, particularly at the early stages of education; but how is professionalism to be learned and assessed? The research results from medical education point to fascinating issues. For example in one study in the USA:

[w]e found that [University of California at San Francisco] School of Medicine students who received comments regarding unprofessional behaviour were more than twice as likely to be disciplined by the Medical Board of California when they become practicing physicians than were students without such comments. The more traditional measures of medical school performance, such as grades and passing scores on national standardized tests, did not identify students who later had disciplinary problems as practicing physicians. [...] we can now advocate from an evidence-based position that professionalism is an essential competency that must be demonstrated for a student to graduate from medical school. (Papadakis *et al* 2004, 249)

A study such as this is directly applicable to the legal profession. Would similar results obtain amongst lawyers? Regardless of the outcome, it is plain that, educationally, ethically, economically, the professionalism of students is bound up, as is the professionalism of lawyers, in the dilemmas of their social and working lives. Regulators need to recognise this as a multi-layered problem, much as they need to recognise the situation of legal educators, caught between an audit culture and their own professional expertise. Indeed if regulators were to take research such as this seriously and act upon it, it could result in a radical realignment of our legal educational system, with undoubted economic effect for providers, students and law service providers.

One example of this is the role that Open Education Resources (OER) could play in a much more open educational ecology, where providers form joint schools or joint ventures on the production of programme materials, particularly in areas that are notoriously expensive, such as the production of digital assets, multimedia and the like. The concept of OER is still controversial, and there are three key issues, all of them economic in implication if not in nature, for legal education providers. First, sharing educational resources globally with users (particularly in developing countries) has a clear philanthropic basis, as research into the MIT OpenCourseWare initiative makes plain – but is it effective in action? Second, the sharing of resources can lead to improvement, faster iteration and wider uptake of the resources – but how best can we operationalize this? Third, there are strategic marketing and branding motivations for providers: OER can persuade users to become students. The wholesale sharing of resources is already well under way in the publishing field, for example with LMS vendor and publishing partnerships.<sup>31</sup> Given this, institutions themselves might give thought to forming partnerships to bring down costs and improve the quality, creativity

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<sup>31</sup> On 7.2.11 Moodlerooms (the provider of enterprise solutions based on Moodle) established a joint partnership with Cambridge Global Grid for Learning, a major content aggregator of digital learning content. The Grid consists of over 40 providers (commercial entities such as CUP, Science Photo Library, Reuters, EduPuzzles, Bridgeman Education) and provides for the whole range of institutional education, from kindergartens to postgraduate education. Blackboard recently announced a similar deal with McGraw Hill and NBC.

and imagination of legal education.<sup>32</sup> It might be said that regulators should encourage this process, since such moves could reduce the cost of programmes for students and for institutions alike.<sup>33</sup> Indeed it might be argued that regulators should go further, and research and argue the general philanthropic and democratic case for use of OER by educational providers. Educational resources, after all, are little more than the “side-effect” of teaching’, as Benkler put it, in his excellent study of social production (Benkler 2006, 327).

Given this, I do not agree with the Report’s general statement that ‘competitive processes should be allowed to operate, since competition is the best discovery procedure that we know’ (p.56), not because I think the statement is inherently erroneous in fact (it will apply to many industries), but because competitive processes do not necessarily produce quality in educational processes. The context, as I have argued, is simply too complex and multi-factorial.

Section 5.4 of the Report, which most closely deals with legal education, is right in its conclusions, but makes no mention of the fact that the market price of programmes such as the LPC has risen substantially in recent years. We do not have clear and regularly updated information such as that produced by the ABA in the USA on prices, student debt and the like.<sup>34</sup> Nevertheless it is clear that the cost of professional programmes (particularly in the light of substantial and imminent increases in undergraduate programme fees from 2012) is causing considerable concern, not just to students but to regulators as well.

Finally, entry requirements, in most common law jurisdictions, are based upon reserved areas that are deemed to be essential knowledge requirements for practice in the profession. The debates around such reservations has been part of almost every major legal educational report in the last half century. Once again, while I agree with the Report authors that these requirements are undoubtedly economic in their gate-keeping effect, decisions to preserve, alter or abolish such restrictions upon providers concerns much more than economic issues. Again, the development of a ‘trading zone’ here would be useful. In addition to lay representation, it would be very helpful for other professional educational personnel to be closely involved in the design of regulatory processes, and in the implementation of those processes. The presence of other professions (possibly also legal personnel from other jurisdictions) would mitigate the dangers of sectional capture of the regulator by interest groups. Similarly, I would agree with the authors that in relation to legal education, a transparent framework of analysis of legal educational services is essential; and that both necessity and proportionality are key economic issues. They are not, however, as I have sought to show throughout this response, the only issues at stake; and we need to

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<sup>32</sup> An interesting example of such a partnership was the Glasgow Graduate School of Law, a joint graduate school formed by the Universities of Glasgow and Strathclyde in Glasgow. The School hosted joint Masters programmes, and innovative professional legal educational programmes. There are of course many problems to overcome: economic, certainly, but also largely political and operational; and issues to do with culture and mindset.

<sup>33</sup> Though of course there are dangers of monopolization and cartelization that should also be recognized by regulators. I agree with the authors that these are matters ‘ultimately a matter for detailed, empirical assessment’ (p.57), and that there is an argument here for public regulation supplemental to competition policy (p.58), to prevent capture of the educational market by regulated providers.

<sup>34</sup> [http://www.americanbar.org/groups/legal\\_education.html](http://www.americanbar.org/groups/legal_education.html)

bear all of them in mind to appreciate the complexity of the problems facing regulators and the direction of possible solutions.

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## Agency, bounded rationality and the moral economy of professional regulation

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The report by Christopher Decker and George Yarrow<sup>35</sup> is to be welcomed for its thoughtful and pragmatic (we mean this in a complimentary way) approach to the economic rationale for legal services regulation. We also welcome the fact that such a report was commissioned by the Legal Services Board as further evidence of that body's commitment to grounding regulation on a sound bedrock of theoretical, as well as empirical, evidence.

A particular strength of this research is its willingness to move beyond traditional 'textbook' economics, and particularly the assumptions of what the authors refer to as "modern neo-classical economics" (MNC).<sup>36</sup> The comparative institutional approach advanced by the report appears to offer some significant advances over the MNC's obsession with market failure.<sup>37</sup> However, this does not mean that we agree that an institutional approach is, without more, sufficient to provide an "economic rationale", or (and this observation is perhaps directed to the Legal Services Board more than the authors) that an "economic rationale" as traditionally understood is ultimately a sufficient basis for justifying regulation (or otherwise). We will take each of these concerns in turn, with reference primarily to the issue of information asymmetry which is recognised as one of the core problems for credence goods such as professional services.

### A central problem: agency and rationality

As Decker and Yarrow note, MNC assumes perfect competition and perfect information. It also assumes perfect rationality. Whilst the deficiencies of assumed perfect competition and, particularly, perfect information<sup>38</sup> have been successfully explored in providing a rationale for regulation, the deficiency in assuming perfect rationality has, until relatively recently, been less considered.<sup>39</sup> Perfect or full rationality assumes that people have well-defined, consistent preferences and that they make decisions that maximise those preferences. These preferences accurately reflect the true costs and benefits of the options available to the individual choosing between them and when making these choices under uncertainty, people will have perfectly-informed ideas related to the rate each risk returns.

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<sup>35</sup> C. Decker & Yarrow, G. (2010) *Understanding the Economic Rationale for Legal Services Regulation*. Oxford: Regulatory Policy Institute.

<sup>36</sup> *Id.*, p.8ff

<sup>37</sup> See also J. Kay, (2007) 'The Failure of Market Failure' *Prospect*, No. 137, August 2007, available at <http://www.prospectmagazine.co.uk/2007/08/thefailureofmarketfailure/> (secured to subscribers)

<sup>38</sup> G Akerlof, (1970) 'The Market for Lemons: Quality, Uncertainty and the Market Mechanism' *Quarterly Journal of Economics*, vol. 84(3), pp. 488-500

<sup>39</sup> C. Jolls et al., (1998) 'A Behavioral Approach to Law and Economics', *Stanford Law Review*, vol. 50, pp.1471-1550

We need to look at these assumptions in the context of the lawyer-client relationship – a classical form of agency relationship. Professional-client relationships create some distinctive agency problems. We argue here that a focus on the “institutional arrangements which govern the process of exchange”<sup>40</sup> does not necessarily adequately address the agency problems created by normal conditions of “bounded rationality” in such relationships. By bounded rationality we mean the tendency for people to make decisions based on limited information and relying on heuristics, or rules of thumb, rather than “rational” calculations of costs and benefits.<sup>41</sup> While economists have traditionally regarded choice as an optimising activity, behavioural economics recognises that choosing in the real world is a complex process that routinely – we might even say invariably - results in strictly sub-optimal – if sometimes relatively efficient - decision-making.<sup>42</sup> Complexity in this context needs largely to be understood as a normal consequence of market operations, resulting in elements of both information overload and information asymmetry. This is partly explained by the fact that many of the services purchased in the legal services market can be characterised as what we have already called credence goods, that is, products whose consumption payoffs or ‘true value’ may be unclear to consumers even *after* they have been purchased. Knowledge, or information, asymmetry is indeed an inevitable feature of professional service markets. As Sharma observes, in professional-client relationships the “division of labor (*sic*) is also a division of knowledge. Hence, the importance of knowledge, not sharply articulated in agency models, is affirmed expressly in the context of principal-professional exchange”.<sup>43</sup> This issue of asymmetry has both demand- and supply-side dimensions.

### **Demand-side rationality**

Information asymmetry is widely considered to favour professional agents, and such problems of information asymmetry have, traditionally, presented the most persuasive case for the regulation of legal services, and for regulation more generally.

The problem of asymmetry is real, but also, as Decker and Yarrow acknowledge, it is not straightforwardly distributed across the marketplace. *Some* consumers of legal services are necessarily poorly informed about specific legal rules and of the choices between actions available that will result in the most efficient, efficacious outcomes. But not all. Institutional clients may not experience the same degree of asymmetry, and, as agency theory predicts, powerful principals may be able to use contractual and other devices to monitor and meter their lawyers’ performance.<sup>44</sup> For themselves, legal professionals may be faced with incentives, financial or otherwise, to under- or over-provide legal services, which can undermine their ability to act as “perfect agents” for their clients.<sup>45</sup> They may also lack full

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<sup>40</sup> R.H. Coase, (1994) ‘The Institutional Structure of Production’, in Coase, R. H. *Essays on Economics and Economists*, Chicago: University of Chicago Press, p.6.

<sup>41</sup> R.B. Korobkin and Ulen, T.S., (2000) ‘Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics’, *California Law Review*, Vol. 88(4) pp.1051-1144

<sup>42</sup> See, eg, D. Kahneman and Tversky, A., (1979) ‘Prospect Theory: An Analysis of Decision under Risk’, *Econometrica*, Vol. 47(2) p.269. See also G. Klein, (2001) ‘The Fiction of Optimization’ in Gigerenzer, G. and Selten, R. (eds), *Bounded Rationality: The Adaptive Toolbox*, Cambridge, MA: MIT Press.

<sup>43</sup> A. Sharma, (1997) ‘Professional as Agent: Knowledge Asymmetry in Agency Exchange’, *Academy of Management Review*, vol.22(3), p.758 at 759.

<sup>44</sup> K. Eisenhardt, (1989) ‘Agency theory: An assessment and review’ *Academy of Management Review*, 14(1): 57-74.

<sup>45</sup> T.L. Greaney, (2009) ‘Economic Regulation of Physicians: A Behavioural Economics Perspective’, *St. Louis University Law Journal*, vol. 53, p.1191

information about clients' real preferences, which makes cogent mapping of preferences to outcomes more difficult.

### Supply-side rationality

Sociological research suggests that professionals' embeddedness in complex professional, social and economic networks necessarily softens their propensity, or opportunity, to maximise their own interests.<sup>46</sup> In addition to the factors which map the patterns of preferences and choices consumers make when faced with incomplete information, studies also show how supplier (not just consumer) choices deviate from those expected from a perfectly rational actor in directions that are not entirely self-interested and are in fact influenced by some notion of fairness.<sup>47</sup> Likewise, reference to and compliance with recognised social or professional norms can guide preferences unpredictably away from the patterns expected of hypothetical rational agents.

So, where does this take us?

### Behavioural economics and regulation

What we are arguing for is an approach that supplements an institutional 'model' with the related approach of what is now commonly called "behavioural economics", an approach that can trace its origins back to the influences of early economic theorists such as Marshall, Tarde and Veblen.<sup>48</sup>

A behavioural economics perspective leads us to argue that any effective economic rationale for regulation must take account, *inter alia*, of the following assumptions:

**Decision-making under even normal levels of uncertainty/complexity is governed by bounded rationality:** Tversky and Kahneman<sup>49</sup> provide many examples which demonstrate that people routinely fail to behave in their own best interests and could be doing rather better for themselves if they were able to recognise these limitations in order to build better

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<sup>46</sup> R. Dingwall, (1983) 'Introduction'. In Dingwall, R. & Lewis, P. (eds), *The Sociology of Professions*, New York: St. Martin's Press, pp.1-13.

<sup>47</sup> D. Kahneman, Knetsch, J.L. and Thaler, R.H., (1986) 'Fairness and the Assumptions of Economics' *Journal of Business*, vol. 59(4), pp.S285-S300 (demonstrating in a simple ultimatum experiment "One player, A. (allocator) is asked to propose a division of a sum of money, X. Between himself or herself and an anonymous player, R (recipient). Player R may either accept A's proposal or reject it, in which case both players receive nothing. The game-theoretic solution to this problem is that A should offer R a token payment and that R should accept any positive offer. The results were not consistent with this presumption." p. S289). See also Kay, above, n.3.

<sup>48</sup> P. Earl (2005), Behavioral Economics and the Economics of Regulation: Briefing Paper Prepared for the New Zealand Ministry of Economic Development, Brisbane: University of Queensland, p.3, available at <http://espace.library.uq.edu.au/view/UQ:8811>.

<sup>49</sup> A. Tversky and Kahneman, D., (1974) 'Judgment under Uncertainty: Heuristics and Biases', *Science*, vol. 185(4157) p.1124:

Many decisions are based on beliefs concerning the likelihood of certain events such as the outcome of an election, the guilt of a defendant, or the future value of the dollar. These beliefs are usually expressed in statements such as "I think that...", "chances are...", "it is unlikely that...", and so forth...What determines such beliefs? How do people assess the probability of an uncertain event or the value of an uncertain quantity?... People rely on a limited number of heuristic principles which reduce the complex tasks of assessing probabilities and predicting values to simpler judgmental operations. In general, these heuristics are quite useful, but sometimes they lead to severe and systematic errors"

models and rules for applied decision making. Bounded rationality also highlights the problematic nature of choice: that we might simultaneously have too much of some kinds of information, and too little of others.<sup>50</sup> It is this constraint on our ability to be fully rational that offers some complementary justification for the need to regulate legal services to ensure that specialist knowledge is not used to exploit such deficiencies in our decision making. Paradoxically (it may seem) deregulatory strategies may, whilst increasing the appearance of consumer choice, actually reduce the possibility of optimal selection.<sup>51</sup>

***It follows also that choice is commonly a “satisficing” activity:*** the costs of solution optimisation may rapidly exceed the benefits, therefore people will “satisfice”, in Simon’s term:<sup>52</sup> that is, select the first course of action that seems to be successful. A valuable function of regulation may thus be to provide effective, and mutually acceptable, heuristics that provide “threshold cut-offs”<sup>53</sup> to determine whether a problem exists (e.g., whether there is an actual conflict of interest or not) or rules of priority for dealing with a particular problem (e.g. what to do once a potential conflict has been identified).

***Choice frequently has an emotional as well as a cognitive dimension:*** emotional states may provide a powerful framework for decision making. Two obvious implications of this principle for legal services regulation are, firstly, that as consumers seeking legal advice will often be dealing with emotionally charged problems, they may not be well-placed to engage in either extensive search, or reflective decision making. Secondly, decision rules that are likely to run counter to strong emotional intuitions or ‘non-negotiables’<sup>54</sup> may be of very limited effect – such as, on the supply-side, any attempt to construct conduct rules that run counter to strongly held beliefs (e.g., on the boundaries of professional autonomy) that are constitutive of professional identity.

## Conclusion

As we have shown, our concern is not to reject an institutional approach, but to supplement it in ways that draw on a(n even) richer interdisciplinary vein of scholarship, and on the basis of more psychologically convincing assumptions about the (ir)rationality of human behaviour than traditional economic models. In this spirit we are perhaps suggesting that institutional and behavioural economics can be tied-in to what we might characterise as a ‘moral economy’ approach to professional regulation, which properly recognises the potentially reflexive influences between markets and moral and cultural norms.<sup>55</sup>

Legal services regulation is a complex mix of ‘local’ (professional) rules, competition law and the private law obligations explicit and implied within any retainer or contract for legal

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<sup>50</sup> Earl, above n.14, p.7.

<sup>51</sup> J. Webb, (2005) ‘Legal Disciplinary Practices: An Ethical Problem in the Making?’ *Legal Ethics*, vol. 8(2), p.185 at 192-3.

<sup>52</sup> H.A. Simon, (1955) ‘A Behavioral Model of Rational Choice’ *Quarterly Journal of Economics*, vol. 69, pp.99-118.

<sup>53</sup> Earl, above n.14, p.7.

<sup>54</sup> Id, p.8.

<sup>55</sup> A. Sayer, (2004) ‘Moral Economy’, available online at <http://www.lancs.ac.uk/fass/sociology/papers/sayer-moral-economy.pdf>; cp. also B. Sanghera *et al* (2009), ‘Introduction’, *Cambridge Journal of Economics*, vol. 33(5), p.871 (special issue on ‘Moral Economy and Development Economics’).

services. Legal services regulation also cuts across the broad division between what Ogus calls 'social' and 'economic' regulation,<sup>56</sup> performing both social functions – enhancing or maintaining access to justice, independence of the legal profession(s) and consumer protection - *and* the economic function of enhancing competition. Thinking about the rule books is without doubt a useful way forward. These functions do tend to require different forms of rule-making and possibly different enforcement strategies. There are certainly opportunities to use the insights of the behavioural approach prescriptively to encourage more optimal decision-making. What might a code of conduct look like if constructed out of a set of fast and frugal heuristics?<sup>57</sup> How different might the rule-making process be if that was our declared intention?

A behavioural approach might also help us to look more closely at what we can reasonably require of consumers in assessing the proportionality of regulation. The idea of the not-entirely-rational-but-learning consumer needs to be taken seriously. The reification of consumer choice as a rationale for deregulation is without doubt problematic from a behavioural perspective, though a more behaviourally-informed approach to choice may be valuable in creating appropriate threshold rules. Similarly, if perceptions of risk are to be used increasingly to guide regulatory decision-making, then we might argue that we would benefit from a more sophisticated perception of risk and risk sensitivity across different transactions and market sectors; one that more fully acknowledges that risk is not just a function of supplier behaviour, but also a product of consumer power/knowledge. The importance for both consumers and suppliers of standards of fairness and other moral or social valuations that, as Kahneman *et al*<sup>58</sup> note, rarely trouble economic analysis also needs to be considered.

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<sup>56</sup> A. Ogus (2002) 'Regulatory Institutions and Structures' *Annals of Public and Comparative Economics*, vol. 73(4), 627-48.

<sup>57</sup> G. Gigerenzer and Todd. P.M., (1999) 'Fast and Frugal Heuristics: The Adaptive Toolbox', in Gigerenzer, G., Todd, P.M. and the ABC Research Group, *Simple Heuristics that Make Us Smart*, New York: Oxford University Press, pp.3-34.

<sup>58</sup> Above n.13.

## **Effective modern regulation of legal services**

**Russell Wallman and Nick Denys**

**The Law Society of England and Wales**

Is specific regulation still necessary for some parts of the legal sector, or is the ordinary law sufficient? If specific regulation is needed, how is it best carried out?

### **Why regulate?**

Regulation exists to protect the public interest and minimise the possibility of consumer detriment. Sector specific regulation – as opposed to relying on the ordinary consumer protection legislation - normally occurs when there is an asymmetry of information between clients and service providers, or where the consequence of low quality work or unethical behaviour are particularly serious. In such situations people often struggle to identify precisely what skills their provider needs and to evaluate the quality of the services they have bought. Legal services – like many medical services – are a prime example of services of this kind.

Specific regulation is provided at present in two main ways – by the statutory reservation of some legal services to legally qualified persons, and by the fact that even unreserved legal services when provided by a solicitor's firm are subject to professional regulation. Indeed there is a strong argument to suggest that but for the fact that the vast majority of legal work for lay consumers is already carried out by qualified lawyers, there would be an urgent need to widen substantially the category of reserved services. Experience shows that when unregulated providers encroach on the provision of legal services, Parliament has often considered it necessary to regulate to extend the ambit of reserved services. That happened in the 1980's when unregulated conveyancers were brought within the regulatory net - and the Council for Licensed Conveyancers was established - and more recently in relation to immigration work. The same approach seems necessary now in respect of will writing and the administration of estates.

Sir David Clementi, in his report published in December 2004, identified six main objectives for a regulator of legal services:

- Maintaining the rule of law
- Access to Justice
- Protection and promotion of consumer interests.
- Promotion of competition
- Encouragement of a confident, strong and effective legal profession
- Promoting public understanding of the citizen's legal rights.

These objectives have largely been translated into the regulatory objectives of the Legal Services Act, with an additional over-riding objective of protecting the public interest.

Professor Stephen Mayson has recently argued that legal activities should be reserved to qualified individuals and entities where:

- 1) regulation, and reservation in particular, is in the public interest
- 2) either other regulatory responses are less effective; or
- 3) reservation affords additional protection to clients.

Lord Hunt of Wirral added a moral importance to legal regulation. “Legal matters often involve people who are anxious, fearful, stressed and confused. With the client sometimes in a vexed state and also in a potentially vulnerable position, legal professionalism provides the essential foundations for trust between provider and client.”

It may well be that the reasons why particular legal services were originally reserved to lawyers included factors such as professional protectionism and ease of tax collection, which are either inadmissible or no longer relevant today. However, as Stephen Mayson’s work has demonstrated, there are still strong public interest reasons for ensuring that key legal services are conducted by those qualified – and properly insured - to do the work. Those important protections for the public can be provided whilst nevertheless fostering competition.

### **How should legal services be regulated?**

So what form should specific legal regulation take? It may be useful to look back briefly at the way in which our current regulatory system developed.

A proliferation of law clubs sprang up in the seventeenth and eighteenth century. This led to a wide range of professional standards, especially as the clubs were principally concerned with the well-being of their members. This started to change in 1739 when the Society of Gentlemen Practisers was born in Lincolns Inn Field. This was the first group of lawyers that gave equal weight to the dual purposes of protecting the interests of its members and furthering the wider public interest. The Society’s overt commitment to improving the conduct of legal practice for the benefit of clients meant that its members came to be highly regarded. The Government of the time wanted to ensure these standards permeated throughout the whole solicitors profession. Accordingly, the Solicitors Act of 1845 formalised the Law Society’s position as owners of the practising register and “solicitor” brand. For over 150 years the solicitor’s profession - along with others in the legal, medical and accountancy spheres - was self-regulating.

There are real benefits to self-regulation. Self-regulation is likely to be much more attuned than external regulation to issues which arise in practice. Self-regulation maximises the chances of securing the willing consent of the regulated community. In the legal context,

maintaining the reputation of the legal profession is a key element in retaining client confidence in the solicitor's profession.

Nevertheless, towards the end of the last century doubts began to emerge about whether a pure self-regulatory model was ideal. Although regulators such as the Law Society were under a legal duty to operate in the public interest, rather than the interests of the profession, there were doubts about whether they were sufficiently well equipped to do so. This was partly a question of the narrow composition of governing bodies – could an almost exclusively lawyer body adequately weigh all the factors which go together to constitute the public interest? But it was also in part a question of perceived conflict of role – could a body one of whose responsibilities was to represent the interests of the profession also take an objective approach to what the public interest required on regulatory issues, particularly when members were subject to election from the profession?

David Clementi wrestled with these issues, analysing the comparative advantages of an external regulator on FSA lines, and of a new basis for professional led regulation.

His recommendation, accepted by Ministers and incorporated in the Legal Services Act, was to reform the profession-led system of regulation rather than replace it with external regulation. Despite the teething problems of establishing the new system for legal regulation, nothing in the recent history of financial services regulation suggests that David Clementi made the wrong choice.

Importantly, David Clementi did not recommend – and the Act did not provide – for institutional separation between the representative and regulatory arms of the professional body. He recognised the benefits – both in terms of ready access to specialist knowledge and cost effective operation – of the regulatory arms operating under the umbrella of the professional body, provided that their regulatory decision making was independent.

The current arrangements thus provide a third way; neither self regulation, nor external regulation. It might be described as 'professional led public interest regulation'. The Law Society's regulatory arm – the Solicitors Regulation Authority (SRA) – has a Board with roughly equal numbers of solicitors and of lay persons. It combines good knowledge of the realities of practice, from its solicitor members, with a strong input from high calibre and widely experienced lay members. The knowledge of practice is perhaps particularly important to understand at a practical rather than merely at a theoretical level the environment in which lawyers operate and the significance of duties to the court and third parties, and concerning conflicts and confidentiality. Consultation with the profession alone would not be sufficient to ensure that these matters are properly understood at Board level.

This model of having the profession closely involved in regulation is of course also the standard approach internationally. Interestingly, it is adopted even when the power exists to bring in complete external regulation. In New South Wales, the Office of the Legal Service Commissioner could operate almost all regulatory powers, but has in fact chosen to delegate much of it back to the Law Society. He recognised the need to utilise the Law Society of New South Wales's proximity to the profession in order to promote effective regulation.

**How can 'professional led public interest regulation' work?**

Under this model there should be a symbolic relationship between the two arms of the professional body. The SRA's job is to establish and enforce the necessary standards. The professional body's job is to help members to achieve that, and to encourage members to aspire to higher standards.

It is vital that professional bodies do not simply advocate abdicate all responsibility for standards to their regulatory arms. To do that would be to undermine one of the key benefits of the approach under the 2007 Act – that independent regulation is both informed by and assisted by deep knowledge of the practitioners of legal work.

The Law Society, as a professional body, has a crucial role to play in making sure that practitioners have ownership of the standards they must abide by. As research has found in other contexts, most breakdowns in trust could have been rectified if there had been better communication between regulators and the regulated. Regulators and providers must establish a common understanding between one another.

It is reassuring that this approach appears to be endorsed by the Legal Services Board. Their Chief Executive, Chris Kenny, said in his recent speech at the launch of the Association of Costs Lawyers that whilst the regulatory body for costs lawyers will not have to kowtow to the Association of Costs Lawyers, “they would be foolish not to listen and give the fullest consideration to the ACL's expert knowledge of the market and the challenges the membership faces.”

The same principle applies across the whole range of legal services regulation.

## **Rationales for Regulation**

**Cosmo Graham**

**University of Leicester**

**School of Law**

Chris Decker and George Yarrow's paper is valuable because it not only provides an excellent overview of the economic rationales for regulation but because, in so doing, it stimulates a number of thoughts about the issues confronting regulators and the possible future direction of regulation. This contribution will offer just a few reflections on issues that have caught my attention, starting with the importance of complaint handling and the possibilities of learning from the experience of financial services regulation. They argue in their paper that one of the general economic reasons that supports the regulation of legal services are the quality problems that arise from the division of knowledge, that is, it is difficult for consumers to assess whether or not they are getting a quality product. The typical market solutions to this problem are the development of reputation and/or self-regulatory systems and of course this latter are typical of legal services.

Good complaints handling systems can help deal with this problem in a number of ways. Complaint handling systems can be internal to the regulated firms or can be external to them, as in the case of the Office of Legal Complaints and the Financial Ombudsman Service (FOS). External systems can help the consumers in a number of ways. First, they provide a means of redress or, to put it another way, a means by which a consumer can have their transaction reviewed by an independent third party who will check the quality of service offered against some criteria of minimum standards. The possibility of recourse by consumers to an external third party provides an incentive on the regulated firms to try and ensure that they meet these standards because there are costs to dealing with such complaints, both direct (case fees) and indirect (management time). In addition, having an external system can help to enhance consumer confidence in the marketplace overall. Research suggests that consumers who complain to their providers are more likely to re-purchase the good or service concerned and this is the case not only when the complaint is successfully resolved but also, counter-intuitively, in those cases where it is not resolved.

External complaint handling systems also have the potential to be helpful to consumers by providing information about the number of complaints against regulated firms and success rates. In the UK context, this has often only been theoretically available. So, for example, neither the Telecommunications Ombudsman nor the Communication and Internet Services Adjudication Scheme (CISAS) provide information on a company level as opposed to, for example, the Australian Telecommunications Ombudsman. Provision of such information has always been highly controversial in the UK, no doubt in part because it can be very damaging to a firm's reputation to be seen as having a high number of complaints. It is often argued, with some justification, that provision of raw data is misleading – a higher market share will lead to, other things being equal, a higher absolute number of complaints. Nevertheless publication of information on complaints can act as an important stimulus for improvement and is also important from the standpoint of transparency – it already takes place in some sectors, such as water services.

A third point about external complaint handling systems, which is often not appreciated, is that they can help consumers through helping the regulators. A string of complaints is often the first indication that there is a problem with a particular industry practice or regulatory rule. Again, this is something that has not always been appreciated in the UK, although it has been an important part of the work of FOS, of which a notable example has been the issue of mis-selling Payment Protection Insurance, which was first raised with the Financial Services Authority by FOS, who also advised the FSA on its approach to ensuring that customer complaints were resolved fairly. In Australia, it is simply the number of complaints received by the Telecommunications Industry Ombudsman which has led to a review of the regulatory system.

For an external complaint handling system to be effective, there are a number of conditions that need to be met and it would be the regulator's job to ensure that any such system worked effectively, although the regulator's powers may be constrained by its statutory mandate. An external system has to be independent, it must be accessible, it must operate fairly and efficiently, it must offer sufficient redress, it must operate openly and in an accountable manner and periodically be subject to review.

Certain analogies can be drawn between legal services regulation and financial services regulation. There are some similarities in relation to the nature of the services, as it is difficult for the consumer to know in both cases whether or not they have bought a quality product. The similarities between the products are interesting, and there would seem to be a lot of sense in legal service regulators keeping an eye on developments in financial services regulation, particularly the Treating Customers Fairly initiative of the FSA, because this may be a source of good ideas or pitfalls to avoid.

There is also some similarity between the current regulatory structure set up for legal services and the one put in place in the mid-1980s for financial services. Then the system was one where a regulator had oversight over a number of self-regulatory organisations, similar to legal services today, but this has now evolved into one where there is a central statutory public regulator. There is no necessary reason why this should happen in relation to legal services, although it is a reminder of what might happen if a self-regulatory system is perceived to be failing.

The paper makes the point that while small changes in regulation or rules may not affect efficiency very much, they may lead to significant transfers of income between suppliers and their customers. In addition, the evidence cited in the paper suggests that if quality standards are set by the profession to which they apply, they are likely to be set too high. They then go on to discuss rationales for the continuing oversight of professional self-regulation which include, among other things, to identify current rules, or combinations of rules, which are inefficient or anti-competitive and to ensure that the process for rule change operates effectively. This analysis highlights the challenges faced by an oversight regulator such as the Legal Services Board, which is smaller than some of the organisations it regulates and where there is a danger a limited number of people, outside of the self-regulatory bodies, will display much interest in proposals for rule change. To put it another way, it will be important for the Legal Services Board to ensure that such processes of rule change are conducted openly and that a sufficient variety of evidence and opinion is taken into account in the process.

The problem will be exacerbated because, as the paper recognises, there are non-economic rationales for regulation in this area, which are enshrined in the statutory regulatory objectives. This makes the process more challenging because, although there may be some well accepted methodologies for assessing the economic costs and benefits of rule and regulation changes (although this is not to say that these are necessarily easy), it becomes more difficult when non-economic public policy objectives have to be incorporated into the decisions.

It is, however, very encouraging that the Legal Services Board has tried to encourage a wider dialogue through the publication of this volume and the seminar on which it is based as well as the other research work it has commissioned and publications based on that because this shows a willingness to consider first principles and to try and invite a broad range of views to inform its decision making process.

## **The consumer's role**

**Steve Brooker**

### **Legal Services Consumer Panel**

The Regulatory Policy Institute identify information asymmetries between suppliers and consumers as providing the most compelling rationale for regulating legal services. This problem is present in all professional markets, but the imbalance of knowledge and power that exists between lawyers and consumers is particularly acute. Legal services are often highly technical, used relatively rarely and sometimes at a time of distress, whilst a lawyer's intervention may lead to the gravest of personal and financial consequences. Even the most confident person, when accused of a crime or faced with unfair dismissal, may feel very vulnerable and powerless. Moreover, whilst a lawyer is someone to turn to for help when confronting a violent spouse, unfair employer or rogue business, challenging a poor lawyer is likely to seem especially intimidating. Mix these ingredients together and it is little wonder that a culture of deference towards the legal profession persists.

A common policy response to tackling problems of information asymmetry is to seek to empower consumers to play their part in driving competitive markets, by equipping them with the knowledge and skills to make informed choices that demand more of suppliers. Indeed, empowering consumers has become something of a holy grail for policymakers. The Department for Business, Innovation and Skills' Business Plan includes a commitment to "introduce reforms to empower consumers".<sup>59</sup> It is also the first objective of the EU Consumer Policy strategy for 2007-13.<sup>60</sup> The Legal Services Act has a similar regulatory objective of "increasing public understanding of the citizen's legal rights and duties". Arguably, however, it has been the least explored of the eight regulatory objectives to date.

### **The rise of consumer power**

In the wider economy consumers are increasingly assertive with suppliers, to the extent that Consumer Focus has heralded the emergence of 'the new consumer power'. Its survey evidence finds that half the population think consumers have more power to influence business and three quarters say they now make more of an effort to get the best deal. At the heart of this shift are the opportunities created by the internet for consumers to collaborate by learning from one another and aggregating their buying power. For example, UK consumers are leaving well over 100 million comments a year on websites about service performance.<sup>61</sup>

The picture in legal services could not be in starker contrast. Surveys show that 60% of the public cannot name a single law firm<sup>62</sup> and 77% of consumers who used lawyers in the last

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<sup>59</sup> Department for Business, Innovation and Skills, *Business Plan 2011-2015*.

<sup>60</sup> European Commission, *EU Consumer Policy strategy 2007-2013*.

<sup>61</sup> Consumer Focus, *Unleashing the new consumer power*, 2010.

<sup>62</sup> See <http://www.lawgazette.co.uk/news/public-unable-name-a-single-law-firm-research-shows>

five years did not shop around.<sup>63</sup> Moreover, 80% of people say that would not know how to tell a good lawyer from a bad one, whilst the same proportion who are dissatisfied with their lawyer do not complain.<sup>64</sup> Research for the Legal Services Consumer Panel's referral fees investigation showed that consumers view legal services as standard products where quality and price do not vary much between suppliers.<sup>65</sup> And the Panel's report on quality assurance found that consumers assume all lawyers are technically competent and tightly regulated.<sup>66</sup> Furthermore, the way in which legal services are provided makes it difficult for consumers to exercise choice. Legal services ranked third bottom for the ability of consumers to compare goods and services in an EU-wide survey comparing consumer outcomes in 50 markets.<sup>67</sup>

## **5 steps towards narrowing the information deficit**

Asymmetries of information in legal services are impossible to remove entirely. Going to a lawyer would be unnecessary if everyone was fully aware of their legal rights and how to exercise them. However, planned strategically and with some imagination, regulation can help to reduce the power imbalance. Here are five areas where regulators could focus their efforts:

### **1. Give people real choice**

The opening of the first ABS companies from 6 October 2011 will end of one of Britain's last closed shops. Consumers have a wide choice of lawyers, but legal services tend to be delivered in similar ways. Without the full force of competition breathing down their necks, law firms have not needed to respond to the changing preferences of an increasingly demanding public. A poll in 2010 that found nearly half of solicitors are impossible to get hold of after 5pm was telling.<sup>68</sup>

Consumer choice should not be completely unfettered; business freedoms must be subject to suitable safeguards to protect consumers. The provision of some legal services should be restricted to qualified persons working within a regulatory framework. However, as highlighted by Professor Stephen Mayson, the current list of reserved legal activities is an accident of history – sometimes the result of backroom deals and prejudice – rather than a coherent policy rationale.<sup>69</sup> The starting point should be to let the market work but be ready to intervene where evidence of consumer detriment exists (or there is a high risk of it), regulation is likely to succeed in addressing the problems and the benefits of regulation to consumers outweigh the costs. It is with this attitude that the Panel is examining the case for regulation of will writing.

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<sup>63</sup> Legal Services Board, *Consumer Research*, December 2009.

<sup>64</sup> Ministry of Justice, *Baseline survey to assess the impact of legal services reform*, 2010.

<sup>65</sup> Legal Services Consumer Panel, *Referral fees*, 2010.

<sup>66</sup> Legal Services Consumer Panel, *Quality assurance*, 2010.

<sup>67</sup> European Commission, *The Consumer Markets Scoreboard: 3<sup>rd</sup> edition*, 2010.

<sup>68</sup> See <http://www.legalfutures.co.uk/practice-points/client-care/half-of-solicitors-impossible-to-get-hold-of-after-5pm-clients-say>

<sup>69</sup> Legal Services Institute, *Discussion Paper: Reserved Legal Activities: History and Rationale*, 2010.

Anti-competitive restrictions on professional rules can also limit choice. These have gradually been eroded following the OFT's report *Competition in Professions*<sup>70</sup>, but regulators should be alert to their reappearance. Last year saw a concerted effort by parts of the profession to reinstate the ban on referral fees. Although many people find the practice instinctively distasteful, the evidence showed they were not causing consumer detriment: they need not compromise the independence of lawyers, or result in lower quality or higher prices.

## **2. Help consumers to make comparisons**

Across the services economy the UK has the highest switching rate in the EU27, in part due to the emergence of price comparison websites.<sup>71</sup> These benefit consumers through helping to promote competition by reducing search costs, facilitating informed choice and increasing consumer understanding and confidence in dealing in the market. However, they have struggled to take off in legal services despite apparent consumer demand – in one poll 42% said they wanted to see them.<sup>72</sup> Some sites dedicated to legal services have started but their usage levels are very low, whilst only two economy-wide sites offer limited 'find-a-quote' search functions for solicitors.

Nevertheless, significant consumer usage of comparison websites in legal services is probably only a matter of time. In anticipation, the sector's regulators would do well to heed the problems in other markets that have dented consumer trust. A survey by Which? found only 30% of members trust comparison websites to find the best price available,<sup>73</sup> whilst 14% of consumers polled by the OFT who had not used one said they did not trust them to produce unbiased results.<sup>74</sup> Investigations have identified issues including a lack of transparency around commercial relationships, manipulation of consumer choice, limited market coverage and privacy concerns about the collection and usage of personal information.

The Financial Services Authority and Ofcom have intervened to tackle problems with such websites in their respective sectors, in order to ensure a level playing field and restore consumer confidence. The Panel is keen to ensure that comparison websites in legal services do not fall into the same traps. Legal services regulators should adopt a 'prevention is better than cure' approach to nip any bad habits in the bud.

## **3. Open up regulatory information about suppliers**

A criticism of price comparison websites is that quality suffers because businesses focus too heavily on offering the lowest possible prices. Regulators could help to counter this by opening up the information they hold about suppliers that do not treat their customers fairly. Although disciplinary action is routinely disclosed, other information that would inform consumer choice is not. Legal services are behind the curve as in other arenas consumers can access complaints information about individual suppliers. Indeed, in financial services both first and second-tier data is available.

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<sup>70</sup> Office of Fair Trading, *Competition in Professions*, 2001.

<sup>71</sup> See note 10.

<sup>72</sup> See note 6.

<sup>73</sup> Which?, *Best price comparison sites*, undated.

<sup>74</sup> Office of Fair Trading, *Internet Shopping: An OFT Market Study*, 2007.

There is much consternation in the legal profession about the website [www.solicitorsfromhell.co.uk](http://www.solicitorsfromhell.co.uk). It invites comparisons with the now defunct website [nthellworld.com](http://nthellworld.com), an online community created by a disgruntled customer of the former cable television company ntl. When the website was threatened with closure due to financial problems, ntl bought it and initially kept it running judging that the likely commercial benefit of learning from customer feedback outweighed the potential loss of revenue from bad publicity. By contrast, some lawyers have challenged the solicitorsfromhell website in the libel courts (with some success). Arguably such websites are unhealthy, but they fill a vacuum that would not exist if regulators published information about the quality of suppliers.

The Legal Ombudsman is agonising over whether to exercise powers in the Legal Services Act to identify lawyers or their firms by name. The Panel has argued forcibly that complaints information would inform consumer choice whilst at the same time provide a strong incentive for lawyers to maintain service standards and respond appropriately to complaints. However, whilst complaints are the focus of current debate, there are other examples of information that could inform consumer choice. For example, the Legal Services Commission could publish the outcomes of peer reviews of firms with which it has contracts for legal aid work. Commercial incentives have been cited as behind steps to force disclosure of diversity statistics within the legal workforce.<sup>75</sup>

#### **4. Make quality signals meaningful**

Addressing problems of information asymmetry is a goal that should be shared by suppliers who provide a good service to consumers, as they will otherwise struggle to differentiate themselves from rivals who cut corners on quality but charge lower fees. This is especially problematic in an environment where there are few recognisable trusted brands and where research shows that consumers assume all lawyers are honest and technically competent.

It is therefore of little surprise that the market has developed quality schemes which make claims of specialisation or higher service standards. However, the Panel's research suggests such schemes have passed individual consumers by, although they have some influence on bulk purchasers and corporate clients. Moreover, suppliers will need to convince a sceptical public that the schemes are worth the paper they are written on, as consumers told us they view quality marks in other sectors as marketing devices rather than reliable guarantees. During 2011 we will take a close look at the standards, monitoring and governance that underpin quality schemes in legal services. This was prompted by our report last year on quality assurance which identified a wide variation of practice in areas such as required number of CPD hours, levels of checking, reaccreditation periods and sanctions.<sup>76</sup>

Industry quality assurance initiatives face the challenge of convincing consumers of their credibility whilst at the same time encouraging sufficient businesses to participate to make them financially viable. However, quality schemes developed by regulators also face tensions as inevitably they develop through a process of negotiation between stakeholders representing different interests. Quality Assurance for Advocates is the first major such initiative since the Legal Services Act. The Panel views the current proposals as inadequate since there is insufficient user input and advocates choose the cases on which they are

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<sup>75</sup> Legal Services Board, *Increasing diversity and social mobility in the legal workforce: transparency and evidence. Consultation paper on proposals to increase diversity and social mobility in the legal workforce*, 2010.

<sup>76</sup> See note 9.

assessed and by whom. It is particularly frustrating that the final advocacy standards are weaker than those originally drafted, presumably due to objections from the legal profession. In situations like these the intervention of the oversight regulator can redress the balance; encouragingly the LSB has signalled its displeasure to the approved regulators.<sup>77</sup>

### **5. Introduce targeted information remedies**

As well as enhancing the wider regulatory framework for all, regulators can also help to empower individual consumers in their dealings with suppliers. The Panel is sceptical that incorporating legal education within the school curriculum, as financial capability has been, would be very useful given legal services are used rarely. Instead efforts should focus on providing consumers with salient information at the time when it can influence their behaviour.

Consumers need encouragement to ask probing questions of suppliers in order to break down their assumptions around lawyers' universal competence. The Panel supports the shift by some approved regulators towards principles-based regulation, but the uncertainty this creates for suppliers about expected standards of behaviour also applies to consumers. We have persuaded the Council for Licensed Conveyancers and the Solicitors Regulation Authority to develop customer charters or similar mechanisms, which distil their codes of conduct into a set of easy-to-understand standards to which the consumers can hold their lawyer accountable.

Requirements on suppliers to disclose specific information can also help to empower consumers. For example, consumers said that being told about a referral fee would prompt them to compare prices, although current poor compliance with disclosure rules by some introducers and solicitors is preventing this. By contrast, obfuscation on the part of suppliers can hinder informed choice. An example is headline pricing where some conveyancers were found to have advertised their costs excluding standard disbursements, thus misleading consumers about the overall price.<sup>78</sup> This is similar to the historic practice by some budget airlines of excluding compulsory airport taxes from advertised prices which led to enforcement action by the OFT. The Panel is under no illusion that information remedies are a panacea, and is aware that too much information can cloud rather than illuminate understanding. Nevertheless, targeted disclosure rules are a first line of defence for consumers who must pick their way through an increasingly complex market place.

### **Conclusion**

The inherent nature of legal services inevitably produces an imbalance of knowledge and power between suppliers and consumers. Other markets demonstrate that consumers are willing and able to exert their muscle, but they require the tools to perform this role effectively. Empowered consumers will reward suppliers who treat their customers fairly and penalise suppliers who provide poor service. If consumers can help to police the market,

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<sup>77</sup> See <http://www.legalfutures.co.uk/latest-news/lwb-poised-to-use-enforcement-powers-for-first-time-in-test-of-credibility>

<sup>78</sup> See <http://www.legalfutures.co.uk/regulation/solicitors/revealsra-complaints-sparked-law-society-guidance-on-headline-pricing>

there is less need for regulatory bodies to do so. Therefore, interventions to empower consumers should enjoy wide support, even if they initially appear threatening.

Some level of regulation will nevertheless be required and anyway not all consumers can develop the knowledge, skills and confidence to become empowered. There is no silver bullet, but the Panel challenges the sector's regulators to think about consumer empowerment more strategically, taking the five themes above as a starting point.

## **Final thoughts**

**Alex Roy**

### **Legal Services Board**

#### **Why?**

The Legal Services Board (LSB) is an oversight regulator of legal services regulators rather than a regulator of individual lawyers. Legal services regulation is complicated by the presence of ten front-line regulators with overlapping responsibilities for individual lawyers and rulebooks often developed over hundreds of years. Our work covers a range of activities which includes both considering appropriate regulatory structures and assessment of proposed changes to individual rules. The LSB is tasked with ensuring that regulation is both effective and proportionate, balancing the needs of consumers, providers and the wider public. The current regulatory model builds on the effective integration of skills and knowledge of the profession, as highlighted in the essay by Russell Wallman and Nick Denys of the Law Society. However, it also recognises, as Chris Kenny noted in his speech to the Association of Cost Lawyers, that “uninhibited by the regulatory work – and free from the questions of impartiality that dogged regulators in the past – the representative bodies can perform to the full that important ‘trade body’ function for their lawyers.”

In commissioning the Regulatory Policy Institute to write a report looking at the economics of legal regulation it was our intention to take a step back from the existing structures and reconsider the purpose of regulation. In essence, where do benefits from regulation arise in legal services and in what circumstances?

Our aim is to use this research to help us develop a framework that allows us to approach regulatory decisions in a transparent and consistent way. Building on Decker and Yarrow’s paper exploring the particular economic features of the legal services market and using existing option appraisal methodologies the framework developed will serve as a standard analysis tool for our work. Analysing the effectiveness and proportionality of regulation will require more than simply the tools available from economics. As Julia Black and Paul Maharg illustrated in their essays, a multi-disciplinary approach is required, creating what Maharg suggests, a “trading zone” of ideas and discourse.

#### **This is not wheel 2.0**

In deciding whether to approve rules or alter the scope of regulation the LSB will base our decisions on an assessment of the costs and benefits of alternative options. Decker and Yarrow’s paper does not challenge this basic premise; indeed their paper highlights the need for empirical analysis when testing any of the assertions. The framework we develop will therefore feature at its heart a standard approach to cost benefit analysis familiar to many who have previously used the Treasury’s Green Book. The key difference in this case will be understanding the particular challenges and objectives for us in overseeing the regulation of the legal services market.

A key, but perhaps overstated, difference between the models of option appraisal adopted by the Green Book and the analysis in Decker and Yarrow is the use of a market failure framework. While Decker and Yarrow adopt an institutional economics approach, which they believe is best suited to the analysis of a complex regulated market; the practical application of this model is not that different to a traditional market failure analysis. When market failure analysis seeks to address failures in a competitive market, the solutions adopted are subject to cost benefit testing and so implicitly retain a recognition that not all market failures can or should be corrected.

Institutional economics does not assume that features of a market are failures - for example information asymmetry is a market feature that leads to specialisation and so can be seen as a part of a competitive market. But, the analysis recognises the potential of these features to act as barriers to ideal market outcomes and so uses the same empirical testing though cost benefit analysis to understand whether regulation or other interventions could improve market outcomes.

### **Key messages from the study**

Four key factors emerged from the paper that will be central to the next phase of our work: importance of quality; public interest; the legacy of self regulation; and the high degree of market segmentation.

A key reason for the regulation of legal services is the nature of the information asymmetry between providers and consumers and the importance of the service to the lives of consumers. Regulation seeks to impose standards on the market, which maintain appropriate levels of quality, whether through minimum educational standards, ongoing quality assessment, action following complaints or other interventions. Concerns in legal services are not only that without regulation quality of service would be too low, leading to poor consumer outcomes, but also that quality and costs of inputs could be too high in absolute terms and too highly specified in detail, unnecessarily raising the cost and reducing consumer access when high quality outcomes are of greatest importance to consumers. The LSB and other regulators will need to develop the measures or indicators of quality to judge the quality of the services provided in order to ensure that regulation is not only effective but also proportionate.

To understand legal services it is essential to consider the role of legal services as “part of the broader social-political-moral landscape that comprises a society’s legal system.” This public interest aspect of legal services is, if not unique to law, certainly a central feature of law that must be considered in any impact analysis. Laurel Terry in her essay emphasised the need to see legal services as part of a system, more than just as individual transactions. The public good nature of the services must be considered as central throughout our analysis - a view shared in separate paper by Stephen Mayson<sup>79</sup>.

Decker and Yarrow also highlighted in their report the extent to which part of the particular challenge in the regulation of legal services is in the complexity of the regulatory structures

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<sup>79</sup>[http://www.legalservicesinstitute.org.uk/LSI/LSI\\_Papers/Institute\\_Papers/The\\_Regulation\\_of\\_Legal\\_Services\\_What\\_is\\_the\\_Case\\_for\\_Reservation/](http://www.legalservicesinstitute.org.uk/LSI/LSI_Papers/Institute_Papers/The_Regulation_of_Legal_Services_What_is_the_Case_for_Reservation/)

themselves. The long history of self regulation, the growing statutory regulation and the mix of professions and regulators creates a complex and overlapping regulatory map. New regulatory proposals must be considered both on their own merits, but also in the framework of existing regulation to understand their overall impact on consumer, market and public interest outcomes. Furthermore, consideration needs to be given to the processes in which the existing rules and regulations are challenged. Should more people e.g. consumer groups be able to suggest change to regulation to provide a more proactive way of improving the regulation of legal services?

Understanding the barriers consumers face though a lack of information on the quality of legal services is another theme much considered by economists and highlighted in the essay by Richard Moorhead. Cosmo Graham expands on this by highlighting the particular need for publication of information on complaints, a view shared by Steve Brooker in his essay suggesting a range of remedies to improve consumer information.

Finally, in all their analysis Decker and Yarrow emphasised the need in analysing the costs and benefits of options to consider the differences across a range of market segments. Market segmentation between different types of consumer, provider and product supplied is essential in assessing changes to the regulation of legal services. This framework must be supplemented by consideration of practical models for understanding consumer behaviours, which are likely to differ in each market segment. Julian Webb and Abby Kendrick use their essay to illustrate the potential for behavioural economics to start to provide some models for consumer behaviour. The LSB has commissioned OXERA to carry out a review to recommend a market segmentation model for this purpose, but much work remains.

### **Applying lessons to the framework**

As noted above, the report itself does not represent a significant diversion from standard methodologies in assessing changes to regulation. The particular issues in legal services highlighted in the report, and noted above, provide the LSB with a basis for building on the traditional Green Book style analysis of public policy. The first stage as set out in the report is to set out the risks to the principal objectives that regulation might set out to achieve – equity, efficiency and access. Clearly articulating the risks up front is essential to ensuring that any interventions considered are well targeted.

Once the risks have been identified it is essential to test whether these risks in practice lead to harm to the objectives. A combination of empirical analysis and literature review is likely to be necessary to gather evidence.

Where evidence is found to demonstrate that the risks do indeed occur in practice and lead to harm to the objectives of equity, efficiency or access, options for intervention need to be considered and contrasted. This stage of the analysis will draw heavily of standard option appraisal methodologies comparing a series of potential regulatory interventions (e.g. information, changes to rules, changes to the scope of reservation) to the base case of no change. It is at this stage in particular where there is a need to segment the markets for analysis and account for the specificities of legal services and existing regulation.

## Conclusions

The Decker and Yarrow paper and the essays included in this publication raise as many questions as provide answers. The essays highlight many other areas of academic study which must be included in looking to further develop our understanding of the market. The next stage for the LSB will be to develop the themes emerging from the paper and essays into an assessment framework that translates the ideas into practical tools for analysis. Firstly, and perhaps most importantly, is the need to better define what we mean by “quality” across the segmentation and how, whether through direct measurement or indicators we can measure this “quality”.

Further work is also required to define and understand what is meant by public interest, in particular to define how and where it differs from consumer interest and where it is more or less important? Public interest is clearly at the heart of legal services but how we translate this concept and use it within an assessment framework will need to be considered carefully over the coming months.

The challenge to segment the market is already being addressed by OXERA in work for the LSB where they are developing market segmentation tools to apply to the evaluation of the impact of the Legal Services Act. This new framework for analysis is likely to highlight further the gaps in evidence about the functioning of the legal services market that will need to be filled in order to assess the impact of proposed changes to regulation. Again, the LSB is already in the process of surveying existing evidence and commissioning new research to fill knowledge gaps.

Policy evaluation must be more than simply finding the evidence that agrees with a starting point of view. It must seek to gather a range of evidence, challenge existing viewpoints and develop a clear evidence to ensure policy developed has solid foundations. Without such a rigorous assessment we stand the risk of imposing unnecessary costs of the profession, restricting consumers’ access to effective legal support and undermining the key role that the law plays in society. The engagement we have had over the past year with RPI and other academics has been invaluable in helping us understand better the challenges we face in ensuring our regulatory decisions account both for the specificities of the legal market and best practice in cost benefit analysis.