Without Prejudice
CLIENTS AND CONDUCT
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OUTCOMES-BASED REGULATION

By Steve Mark, Legal Services Commissioner (NSW)

On 30 April 2009, the Council of Australian Governments (COAG) resolved that the following measures be instituted to reform the regulation of the legal profession:

- Legislation be drafted providing uniform laws relating to the legal profession across Australia;
- A specialist taskforce be appointed by the Attorney-General to make recommendations and prepare draft legislation;
- A consultative group be appointed by the Attorney General to advise and assist the Taskforce.

Following the COAG meeting, the Taskforce and Consultative Group was created. A Working Group was also created to provide policy, technical, administrative design and advice and secretariat support to the Taskforce. The Taskforce has been tasked with designing a "high level regulatory framework" which "creates and supports a national legal profession", "provides clear and accessible consumer protection and is "efficient and effective" and "robust, relevant and effective over time." To date the Taskforce has published 7 papers. The papers cover the following topics:

- Fidelity Cover
- Trust Accounting
- Professional Indemnity Insurance
- Business Structures
- National Legal Services Ombudsman
- Legal Costs
- Regulatory Framework

The work of the Taskforce has been geared towards drafting legislation that is outcomes-based rather than proscriptive. The move to outcomes-based legislation marks an important departure from the current legislative framework. Outcomes-based regulation will have a substantial effect on the practice of law in Australia.

What is outcomes-based regulation?*

Outcomes-based regulation means moving away from reliance on detailed, prescriptive rules and relying more on high level, broadly stated rules or principles to set the standards by which regulated practitioners and firms need to practice. The use of principles, rather than reliance solely on more detailed and prescriptive rules, has been a feature of the regulatory regime for financial services in the United Kingdom since the 1990s.

Outcomes-based regulation was recently recommended as the preferred approach for the regulation of the legal profession in the UK by Lord Hunt of Wirral in his review of the regulation of legal services.

In an outcomes-based regime regulators worry less about dotting the "i"s and crossing the "t"s, and instead evaluate practitioners and firms behaviour according to broad principles. These principles are usually considered to have the following characteristics:

- they are drafted at a broad level of generality, with the intention that they should be overarching requirements that can be applied flexibly;
- they contain terms that are qualitative and not quantitative;
- they usually contain evaluative terms (ex. "fair", "reasonable", "suitable") as opposed to "bright line" rules (ex. "within two business days");
- they are purposive, expressing the reason behind the rules;
- they are largely behavioural standards; and
- they have very broad application to a diverse range of circumstances.

* Information in this paper is largely based on a paper by Julia Black, Martin Hopper & Christa Band, "Making a success of Principles-based regulation", (17 May 2007) *Law and Financial Markets Review*, Vol 1, No.3 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1146977

Potential benefits of outcomes-based regulation

Outcomes-based regulation focuses on what is actually being provided to the client rather than whether detailed rules are being breached. The former may well involve the latter but the approach is more qualitative. This approach means that practitioners and firms are better placed than regulators to determine what processes and actions are required within their business to achieve a given regulatory objective. There are numerous potential benefits of outcomes-based regulation for the regulator, the profession and consumers:

- In general, an outcomes-based approach requires regulated entities to meet certain high level principles in conducting their operations. Such an approach has the advantage of being flexible for both the regulated and regulator.
- A second advantage to outcomes-based regulation is its focus on risk. Risk-based regulation is advantageous because it inherently requires regulators to incorporate cost-benefit judgments into their decision-making. Focusing on risk also helps regulators to prioritize their responsibilities and leverage limited resources to their best advantage.
- Outcomes-based regulation also has a significant advantage over rules-based regimes because it enhances the regulators' ability to work cooperatively with other regulators.
- Outcomes-based regulation can enhance compliance by promoting behaviour which is congruent with the objectives of regulation.
- Outcomes-based regulation can focus on the purpose behind the rule rather than just on the derailed provisions.
- Principles are hard to manipulate, making creative compliance difficult.
- Outcomes-based regulation can lead to a greater degree of substantive compliance with the purpose of the rule, rather than a "box-ticking" approach, as they require firms to think through how to comply; as such hey can be directly linked to management-based regulation.
- Outcomes-based regulation can provide a basis for open dialogue between regulator and regulated firm, facilitating a co-operative and educative approach to supervision, particularly with respect to firms who are well-intentioned, but either ill informed, or simply confused as to what the regulatory provisions require.

Risks and challenges of outcomes-based regulation

Outcomes-based regulation is not meant for all markets, especially emerging ones where the certainty of rules is needed by regulators and industry. This approach works best in mature, self-regulated markets where developed relationships between the regulated and regulators exist. Otherwise, the trust and expertise is not present to allow the system to function effectively. Other challenges include:

- Outcomes-based regulation also requires proper training and maintenance. With outcomes-based regulation, staff must employ their experience and judgment in making sound regulatory decisions.
- Outcomes-based legislation is more qualitative than quantitative and this adjustment takes time. Early in the transition, staff can occasionally be paralysed by their fear of making the wrong call and this can lead to a regulatory impasse.
- Not all regulation will fit intro the outcomes-based model. On some occasions the regulation may require fixed rules.
- Guidances drafted to assist interpretation of the principles can be unhelpful if it is not consistent with the purpose of the principle.
- Care must be taken when dealing with outcomes-based regulation with the methods used to explain or give substance to the principles, to create clarity and consistency.
- An example of how this can go wrong is seen in the UK where speeches given by regulators of the financial services industry extolling the virtues of "mystery calling" (where a number of the regulatory staff would contact a financial services industry provider pretending to be a prospective client and attempt to discover weaknesses in their service delivery). Whereas, this may be a useful tool as the speeches were given by the regulators, it was assumed by the industry that it was a requirement not just a tool. Accordingly, all financial services providers now use this method as they consider it a requirement.
- There is also the problem that the legal profession tends to view anything stated by a regulator as the right way rather than just a suggestion or an alternative way of approaching the problem.

Pre-conditions for making outcomes-based regulation a success

The risks and challenges posed by an outcomes-based regulatory regime can be overcome with careful consideration and planning. The following measures may be able to assist in overcoming such challenges:

a. Developing criteria to identify the appropriate balance between principles and other types of rules;
b. Taking care in striking the right balance between the provision of guidance on the meaning of the principles and avoiding the need to avoid the dangers inherent in the proliferation of guidance.
c. Meeting the needs of different practitioners and firms;
d. Ensuring an appropriate style of supervision and enforcement and a balance between the two;
e. Redefining the role of decided enforcement cases;
f. Ensuring that the accountability mechanisms in the regulator's rule making process are not by-passed;
g. Changing the skills and mindset of regulators and practitioners/firms;
h. Developing and maintaining a constructive dialogue between the regulator and the regulated as to the expectations and responsibilities of each in interpreting and applying the principles.

In order for these conversations to occur practitioners and firms will have to accept responsibility for thinking through the application of the principles or rules in their own particular context. The regulator has, in turn, to support practitioners and firms in exercising this responsibility by giving firm commitments to the acceptability or otherwise of the responses firms develop to the principles as part of the supervisory process.

How outcomes-based regulation works in practice

The regulation of incorporated legal practices (ILPs) is a good example of principle-based regulation in action.

In NSW solicitor/directors of ILPs are required ensure that the incorporated practice has "appropriate management systems" to render the practice compliant with the *Legal Profession Act 2004 (NSW).* As appropriate management systems are not defined, this fits within the rubric of principle-based regulation. The OLSC"s approach in defining the 10 elements that management systems should address to be considered appropriate gives guidelines for the profession in meeting the regulatory standards. For example, objective 5 of the OLSC's appropriate management system relate to costs disclosure and billing. The objective states as follows:

> "Cost disclosure/billing practices/ termination of retainer (providing for shared understanding and appropriate documentation on commencement and termination of retainer along with appropriate billing practices during the retainer)"

The self-assessment form in relation to objective 5 guides practitioners as to the key concepts that they might want to consider when addressing the objective. The key concepts for objective 5 include for example:

- "The use of established new client engagement procedures including universal use of approved retainer/ costs agreements."
- "Standardised procedures for collecting client data, opening of new files and the recording of data within the firm's accounting and practice management systems with provision for separate client records in the case of multi-disciplinary practices."

The self-assessment document then provides examples of what an ILP *may* do to evidence compliance with objective 5. For example, in relation to "[s]tandardised procedures for collecting client data, opening of new files and the recording of data within the firm's accounting and practice management systems with provision for separate client records in the case of multi-disciplinary practices", the self-assessment form suggests practitioners may want to use a "disclosure policy (eg whether or not taking advantage of exceptions to disclosure, policy about disclosure of costs of non-legal services used in the legal matter) with a process ensuring disclosure is made in accordance with the Act, Rules and Regulation." The self-assessment document also suggests "an up to date File/Matter Register or Practice Management system listing files and individual client files (complying with Rule 13 as to files and file register).

We know that by meeting this standard, incorporated legal practices experience a wide reduction in complaints against them.

RECENT PAPERS/ARTICLES

MANDATORY CLE, NEWCASTLE LAW SOCIETY, NEWCASTLE

On 19 October 2009 the Commissioner presented a mandatory CLE Seminar run by the Newcastle Law Society in Newcastle. The seminar entitled *"Competing Duties – Ethical Dilemma's in Practice"* provided attendees with a general discussion of aspects relating to practical legal ethics and professionalism. The Commissioner discussed the traditional ethical duties of a legal practitioner as set out in the *Legal Profession Act 2004 (NSW)*, the *Legal Profession Regulations 2005 (NSW)*, the *Revised Professional Conduct and Practice Rules 1995 (Solicitors' Rules)* and the *NSW Barristers' Rules (Barristers' Rules)* and then spoke about how the ethical duties have evolved and changed in light of the introduction of legislation that now permits law firms to incorporate and list on the Australian Stock Exchange. The Commissioner suggested that the requirement that legal practitioners undertake continuing professional education is a positive development because it can provide an opportunity for legal practitioners to explore and address ethical issues that arise in practice.

NEW RULE 42 FOR IN-HOUSE COUNSEL, LEGALWISE SEMINARS PTY LTD, SYDNEY.

On 12 November 2009 the Legal Services Commissioner presented a seminar for in-house counsel entitled *"Walking the Ethical Tightrope: Balancing the Responsibilities of In-House Counsel to Key Stakeholders."* The Commissioner discussed the changing role of the in-house counsel from moral compass to moral conscience and beyond and argued that the recently assumed role by in-house counsel of being the moral conscience of the corporation for whom they are employed and gatekeeper is clearly anchored in the public interest and is thus very much in tune with the overriding purpose of the legal profession – to protect the individual from the injustices of the state.

ASIS INTERNATIONAL 4TH ASIA-PACIFIC CONFERENCE, SYDNEY

On 3 February 2010, the Legal Services Commissioner presented a paper at the ASIS International 4th Asia-Pacific Conference in Sydney. The paper entitled, *"Reshaping Security with Culture"* discussed the concept of security and its relationship to identity and culture. Focusing on terrorism and terrorist-related activity the Commissioner argued that a cultural approach to dealing with the risk of a terrorist attack should be considered in lieu of the traditional military or legislative response. The cultural approach centres on the notion of community building; that is, using measures to strengthen social cohesion within the community to ensure that every person can feel valued, involved and engaged. The ultimate aim of the community-based approach is to ensure social sustainability.

Copies of the Commissioners paper are available on the OLSC website at **http://www.lawlink.nsw.gov.au/olsc**

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