Outcomes-Focused Regulation – the Main Changes

On October 6th 2011, solicitors will wake up to a brand new world. Not only will they have a new rule book governing their lives, but the whole shape of the way that legal services are delivered to the public will be changed forever by the advent of Alternative Business Structures. I have already talked and lectured extensively about these changes. My conservative estimate is that around 75% of solicitors do not have any real idea what is shortly to break upon the profession. Readers of this Bulletin fall into the 25% of those who know what is happening. The purpose of this article is to explain how outcomes-focused regulation will be different, not at a philosophical level, but on the ground, where it matters.

Core Duties versus Principles.

The 2007 Code of Conduct set out 6 core duties in Rule 1. These have been retained in much the same form, but expanded to 10 over-arching Principles, which should govern everything that solicitors do. General guidance on the application of the principles is set out within the Code in the following terms:

“They define the fundamental ethical and professional standards that we expect of all firms and individuals (including owners who may not be lawyers) when providing legal services. You should always have regard to the Principles and use them as your starting point when faced with an ethical dilemma.

Where two or more Principles come into conflict the one which takes precedence is the one which best serves the public interest in the particular circumstances, especially the public interest in the proper administration of justice. Compliance with the Principles is also subject to any overriding legal obligations.”

Principles 7 and 8 are imported from the former rules 20 and 5 of the 2007 Code, without material change, and principle 10 reflects the obligations imposed by the Solicitors Accounts Rules (to be renamed the SRA Accounts Rules) but extends to other assets such as documents and anything else entrusted to the solicitor. It is questionable whether this adds anything of substance. The one Principle which changes the comparable obligation imposed by the 2007 Code is principle 9 on equality and diversity. Principle 9 and chapter 2 of the Code go further than the ordinary law in imposing a positive obligation to “encourage” equality of opportunity and respect for diversity as well as a negative obligation to avoid discrimination, and
to adopt policies for these purposes. Quite what this additional element, encouragement, will mean in practice is unclear.

**Rules and Guidance versus Outcomes and Indicative behaviours**

The 2007 Code was based around a series of detailed and prescriptive Rules, supplemented by detailed guidance. That approach has been abandoned, with the result that the 2007 Code has shrunk from well over 200 pages to less than 50, although parts of the 2007 Code have been transplanted into parts of the SRA Handbook, which weighs in at over 500 pages. Whereas Outcomes are mandatory, Indicative Behaviours are not. However, many of the Indicative Behaviours look suspiciously like rules, and time will tell the extent to which they (or some of them) become seen as rules under a different name. The SRA has rightly decided to offer very little be way of supplemental guidance.

**Commissions paid to solicitors**

The 2007 Code was something of a dog’s dinner on the subject of commissions paid to solicitors. Whereas Rule 2.06 appeared to permit solicitors to keep commissions provided that they had the informed consent of their clients to do so (which is the general law), the Guidance associated with the Rule appeared to suggest the precise opposite. In successive editions of The Solicitor's Handbook, Andrew Hopper QC and I criticised this inconsistency, which resulted from a misunderstanding of the leading case, *Law Society v Adcock and Mocroft* [2007] 1 WLR 1096.

The rule on commissions in the new Code (outcome 1.15) is simplified: “you properly account to clients for any financial benefit you receive as a result of your instructions”. There is no longer a de minimis £20 figure below which the rules do not apply, and the word “commission” does not appear in the relevant outcome, being replaced with “financial benefit” which is defined thus: “Financial benefit: includes, for example, any commission, discount or rebate, but does not include your fees or interest earned on any client account”.

Under the general law, a solicitor as a fiduciary must not make a secret profit, and must inform his client of all relevant matters concerning the client’s matter. The general law is satisfied if the fiduciary obtains the informed consent of the client at the outset of the retainer to retention of a financial benefit. So far so good: the general law and O(1.15) appear to be entirely consistent. Regrettably however, confused non-mandatory guidance accompanies the stated outcome, which repeats the contradictory guidance to rule 2.06 – but crucially still without any explanation.

Indicative behaviour IB(1.20) refers to “keeping a financial benefit only where you can justify keeping it, you have told the client the amount of the benefit ... and the client has agreed that you can keep it.”

Indicative behaviours are not mandatory. There is no explanation as to how a solicitor may “justify” retaining the benefit. It is most unfortunate that IB(1.20) has found its way into the new Code. No explanation has ever been given as to what the SRA would perceive as appropriate justification.
Referral fees paid by solicitors

Referral fees are commissions moving in the opposite direction, ie from solicitor to introducer. Solicitors up and down the land will be painfully familiar with the long list of prescriptive requirements set out in the 2007 Code as to what had to be disclosed to the client: the 2007 Code sought to ensure that solicitors acted throughout in the best interests of their clients, and did not compromise their independence. The requirements were unnecessarily detailed. Mercifully, they have now been abolished. The long list of actions that solicitors had to take to comply with Rule 9 of the 2007 Code has been removed. The 7 outcomes required by Chapter 9 of the new Code centre upon maintaining the solicitor’s independence, protecting the best interests of clients, and ensuring transparency. The Chapter 1 outcomes are also relevant in this context: the client must be treated fairly. Although Outcome (9.4) requires that clients are informed of any financial interest which an introducer has in referring the client to the solicitor, the rule does not mandate when this has to be done. IB(1.4) to Chapter 1 suggests that solicitors should explain any arrangements such as fee-sharing or referral arrangements which are relevant to the client’s instructions. O(9.7) requires financial arrangements between solicitors and introducers to be in writing, and O(9.6) outlaws referral fees in respect of clients who are the subject of criminal proceedings or who have the benefit of public funding.

Solicitors should be wary of departing too far from the transparency requirements of the 2007 Code. The elaborate framework in Rule 9 of the 2007 Code was designed to ensure that clients were put fully in the picture about referral fees at the very outset. It is likely to remain best practice for solicitors to inform their clients of the fact and amount of a referral fee at that stage, and the SRA will be able to point to O(9.3), (9.4) and IB(9.5) in this regard. Moreover, the Legal Services Board has recently reported on this issue. While continuing to consider that referral fees should not be outlawed, the LSB is strongly of the view that transparency is essential.

Fee-sharing

The rule against solicitors fee-sharing with non-solicitors was traditionally based upon the risk of a non-solicitor having an inappropriate amount of influence over a solicitor in the handling of a claim for a client. It was steadily eroded over the years. Historically there was an absolute prohibition, but that was relaxed in March 2004 to permit fee-sharing with those who introduced capital or services into a firm.

The advent of Alternative Business Structures in October 2011 means that the old objection to fee-sharing between solicitors and non-solicitors has fallen away. The whole purpose of the reforms is to permit non-lawyers to share profits with solicitors. Fee-sharing will be inevitable where, for instance, a company merges with a firm of solicitors to create an ABS, or sets up an SRA-regulated subsidiary to provide legal services to existing clients. If fee-sharing will be permissible within one overall corporate structure from October 2011, there is no logical reason why fee-sharing between two independent corporate structures should be outlawed. In order to make such an important distinction, clear rules would have to be made so that solicitors could know where they stood.
Accordingly, the rule against fee-sharing is no more. In a nutshell, solicitors will simply have to (a) be transparent to clients about arrangements with fee-sharers, (b) ensure that there is no sacrifice of their independence (i.e. permitting the fee-sharer inappropriate influence), and (c) ensure that the best interests of clients remain paramount.

**Conveyancing – acting for vendor and purchaser**

Chapter 3 of the new Code, which is the successor to rule 3 of the 2007 Code, involves in part a restatement of current principles and rules and in part fairly radical changes. Much of the former rule was concerned with domestic conveyancing, and the circumstances in which a firm could act for both buyer and seller, as well as for lender and borrower. That part of the rule, and its many predecessors, imposed limitations on the ability of a firm to act for both parties, even if no conflict of interest existed. In other words, it was accepted that there was no inherent conflict of interest in acting for buyer and seller, but by regulation going beyond the requirements of the common law solicitors were prevented from acting for both parties in most circumstances, even when there was no conflict. Solicitors were permitted to act for both parties, by exception to the general rule, in limited circumstances (for example where both were established clients and gave written consent), but the exceptions did not apply if there was a conflict of interest.

A rule having this effect was first made in 1972 but the earliest commentary on the subject, in the 1960 Guide to the Professional Conduct and Etiquette of Solicitors, stated firmly:

“... there are a good many conveyancing transactions in which the possibility of a conflict of interest between vendor and purchaser is remote and is rarely experienced in practice. There is thus nothing inherently improper in a solicitor acting for both vendor and purchaser... The complete cessation of the practice of acting for both parties would cause hardship and inconvenience to the public, particularly where both parties are already established clients of the same solicitor...”

The new rule reflects the view of the SRA that this is no longer correct. In its policy statement on its October 2010 consultation the SRA states its view:

“... the circumstances in which either there is no conflict of interests nor a significant risk of a conflict of interests as between buyer and seller must be extremely limited... There may, of course, be some conveyancing situations where there are no conflicts of interests, although, for example, as between a seller and a buyer we expect that these will be rare. Our intention was not to prohibit acting in such cases, but rather to put the onus on firms to make the assessment as to whether a conflict exists.”

The SRA has not yet explained why and on what evidential basis it has come to the conclusion that something that has always in the past been thought not to involve an inherent or overwhelmingly likely conflict, now does. This is likely to have a profound effect on conveyancing practice.
Chapter 7 – the profoundest change of all?

This chapter is the successor to rule 5 of the 2007 Code; it emphasises that everyone has a role to play in the efficient running of a business, although of course that role will depend on the individual’s position within the organisation. The responsibility for the management of the business in the broadest sense rests with the managers. The managers should determine what arrangements are appropriate to meet the outcomes, having regard to the size and complexity of the business; the number, experience and qualifications of the employees; the number of offices; and the nature of the work undertaken.

Chapter 7 marks a significant move towards a more aggressive regulation of business management. Although many of the words are familiar, whereas rule 5 was mainly concerned with ensuring that firms had “systems” including for example systems concerned with financial control, there was no regulatory obligation to ensure that the business was financially sound, with the consequence that if it was not, it would become a matter of interest to and potential action by the regulator.

However outcomes focused regulation, is focused on risk, and risk avoidance. For example, a firm in which no partner or employee has ever been guilty of misconduct in the traditional sense, which has complied meticulously with the Accounts Rules and to whom any breach of the rules of conduct would be anathema, may nevertheless feel the full force of regulatory interest and supervision if it constantly struggles to stay within its overdraft limit, and to pay the VAT, PAYE, and rent on time. For these are indications that the firm may not be viable, or that the partners are imprudent in terms of the level of drawings.

Not long ago, if the question were to be asked: “Is it professional misconduct to fail to pay the office rent?” the answer would have been that the regulator was not a debt collection agency and business debts did not raise issues of conduct, although depending on the facts it might trigger a precautionary inspection of the firm’s accounts because of the enhanced risk that money might be ‘borrowed’ from the client account in such circumstances.

The current view would be that the same facts would amount to a breach of outcome O(7.4) – monitoring financial stability and taking steps to address identified issues. A firm might be required to demonstrate the steps that are being taken to deal with the situation, including redundancy programmes, a freeze on drawings or capital injection, or an acceptance that the business has become unviable and that a plan for the orderly closure of the practice is required, under the SRA’s supervision.

It will be important to have regard to the roles of Compliance Officers for Legal Practice and Compliance Officers for Finance and Administration (COLPs and COFAs) under the SRA’s Authorisation Rules, and to understand the responsibilities of those individuals on the one hand, and of the managers of the practice on the other. Every regulated entity, and not just a new ABS, must have a COLP and a COFA: it is vital that their roles are understood by those in charge of the regulated entity.
Gregory Treverton-Jones QC is joint author with Andre Hopper QC of *Outcomes-focused regulation- A Practical Guide* to be published by the Law Society in August 2011.