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Regulatory Sandboxes for the Legal Industry

Posted on August 7, 2019 by Jayne Reardon
Change doesn’t come rapidly in law. That’s a good thing. The rule of law is predicated on predictability and consistency with precedent. However, if the rapid pace of change in technology and globalization leaves law behind and out of the equation, that’s a problem. Here’s where the idea of regulatory sandboxes may help.

What’s a regulatory sandbox?

“Regulatory sandbox” refers to a way for companies and regulators to experiment with new types of services and technologies to best determine how to regulate them. According to a paper written by Jorge Gabriel Jiménez, a fellow in Stanford Law School’s Legal Design Lab, and Margaret Hagan, director of the Legal Design Lab, a regulatory sandbox is:

“a safe playground in which to experiment, collect experiences, and play without having to face the strict rules of the real world. The private sector can innovate without worrying about fines or liability, the regulatory agency can test regulations to see what works before going through the long process of creating new rules, and consumers have access to these services in a controlled environment. The goal is to relax or change existing regulation in a controlled and evaluated space to run real-world experiments. These experiences can be collected and inform evidence-based regulatory schemes.
The figure below (from “The Use and Regulation of Technology in the Legal Sector Beyond England and Wales” by Alison Hook, co-founder of the research and consulting house Hook Tangaza) describes how sandboxes work:

### Source: EY Analysis

Rather than one-size-fits all, regulatory sandboxes operate on a case-by-case basis. Individual firms propose regulations for their innovation proposals and bear the burden of setting a new and improved regulatory environment for their vision. They test this vision while agreeing to abide by the regulator’s principles and limitations. This includes regular evaluations, prescribed time period, customer communication and so on.

*A timeline approach to sandboxes advanced by Jimenez and Hagan.*

<table>
<thead>
<tr>
<th>Type</th>
<th>Common “customer safeguards”</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Boundary of sandbox environment</td>
<td>• Fixed time period of the sandbox (e.g. usually half a year to a full year)</td>
</tr>
<tr>
<td></td>
<td>• Number of customers</td>
</tr>
<tr>
<td></td>
<td>• Type of customers (e.g. retail/professional, age, income level)</td>
</tr>
<tr>
<td></td>
<td>• Exit strategy for test failure and discontinuation</td>
</tr>
<tr>
<td></td>
<td>• Transition plan for full deployment</td>
</tr>
<tr>
<td>2 Customer protection measures</td>
<td>• Client onboarding requirements</td>
</tr>
<tr>
<td></td>
<td>• Disclosure requirements (about the test and available compensation)</td>
</tr>
<tr>
<td></td>
<td>• Dispute resolution process (e.g. PII)</td>
</tr>
<tr>
<td>3 Risk management measures</td>
<td>• System stability, cybersecurity and data privacy</td>
</tr>
<tr>
<td></td>
<td>• Organizational competence</td>
</tr>
</tbody>
</table>
Where did regulatory sandboxes come from?

The concept of regulatory sandboxes first appeared in the financial services sector. Since the 2007-08 financial crisis, both regulation of the financial sector and investment in financial technology (fintech) have taken off.

The United Kingdom’s Financial Conduct Authority launched the sandbox concept in 2015 in response to the idea that the financial services industry needed to be able to conduct its own equivalent of drug trials.

According to Hook’s paper, the sandbox’s objectives are to:

- Enable firms to test products and services in a controlled environment
- Reduce the time it takes to develop new services at potentially lower cost
- Ensure that appropriate consumer protection safeguards are built into new products and services
- Provide better access to finance for innovative types of services
Fintech sandboxes have also been sponsored in Singapore, Abu Dhabi, Australia, Mauritius, the Netherlands, Canada, Thailand, Denmark and Switzerland. In 2018, Arizona launched a fintech regulatory sandbox to promote entrepreneurship and investment in blockchain, cryptocurrencies and other emerging technologies.

Levels of investment in fintech have risen from less than $3 billion in 2011 to over $100 billion in 2018, according to Hook Tangaza. Flexibility in regulation is credited as one of the reasons behind increased investment.

**Where legal stands**

It’s no secret that legal tech, or technology at the intersection of law, is growing. Venture capitalists invested over $1 billion in legal tech businesses in 2018. Stanford University compiled an international catalogue of 1,200 legal tech businesses—the largest and best known index in the field.

However, much legal tech activity is aimed at cultivating efficiencies in law firms and corporate legal departments, rather than at improving the delivery of legal services themselves. For example, Evolve the Law’s directory of U.S. legal tech businesses includes 58 organizations that target “BigLaw” or corporate legal departments and only five that are consumer facing.

Developments designed to create greater efficiencies within law firms are less likely to raise regulatory red flags compared to those entering the murkier waters of consumer-facing technologies. Unsurprisingly, most firms report regulatory and legislative hurdles as the most important barriers to innovation.

According to some experts, modifying how the legal profession is regulated could improve innovation, spur new businesses and increase access to justice.

As I’ve written before, William Henderson, professor at Indiana University’s Maurer School of Law, says the existing ethical rules should be changed to allow greater collaboration across law and other disciplines. This, in turn, could drive down costs, improve access to justice, aid the growth of new businesses and elevate the reputation of the legal profession.

Similarly, Jimenez and Hagan argue that proper regulation can play a crucial role in overcoming the legal profession’s “access to justice crisis and widespread dissatisfaction among legal buyers.” In can also “promote competition, encourage innovation, and ensure appropriate safeguards for consumers.”

**Fintech as a model for legal**
Fintech regulation is ahead of legal in many ways. While, such regulation is grappling with transparency and accountability with respect to digital banking, AI and data security, regulators realize they must react to the digital revolution. In fact, the Competitive Enterprise Institute has stated that the Consumer Financial Protection Bureau’s “failure to promote innovation and competition as part of a consumer protection framework is an explicit violation of the Bureau’s objectives.”

The anticipated developments in fintech regulation that Hook’s paper outlines could serve as a model for legal tech. These include:

- A growth in sophistication of the use of sandboxes. Technologies with a more mature and better-defined scope will have shorter approval processes and defined criteria for graduation. Less mature technologies with a more uncertain balance of consumer benefits and risks might follow a slower or different path.
- A projected increase in cross-border cooperation with the prospect of multilateral “fintech bridges.” Some authorities have signed cooperation agreements that pave the way for regional or multi-lateral experimentation with regulation.
- A push for industry certification both within and across jurisdictions. These will be particularly in demand for areas that require specialized knowledge, such as robo-advice for investment, cryptography in blockchain applications and credit-scoring models in alternative lending.

**The legal regulatory sandbox**

A regulatory sandbox for the legal industry would allow experimentation with new approaches to business models and legal technology. The sandbox would enable a safe environment for businesses to test services and products without the risk of being sued for the unauthorized practice of law.

In return, regulators could require participants to incorporate appropriate safeguards to protect the public interest, collect and share data, and support competitive innovation in the legal market. Regulators could assess proposed regulatory approaches without adopting them full-scale. It might be a win for all.

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