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Solicitors Regulation Authority
Regulation and Education - SRA Accounts Rules 2017
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By DX and email: consultation@sra.org.uk

19th September 2016

Dear Sirs

RESPONSE OF THE CLLS PROFESSIONAL RULES AND REGULATION COMMITTEE TO THE SRA'S CONSULTATION "LOOKING TO THE FUTURE: SRA ACCOUNTS RULES REVIEW"

General

1. This consultation is predicated on a presumption that there is an inherent flaw in the current SRA Accounts Rules which needs correcting, and that the solution is simplification per-se. We do not believe that the evidence presented supports this conclusion.

   The consultation fails to consider the extent to which the high standards of conduct, consistently applied by virtue of the depth and breadth of the current rules, have historically prevented material breaches from arising and thus contributed positively to protecting clients and client money. The effect of over simplification, and the flexibility of approach which the draft rules facilitate, could have unforeseen consequences and result in lower standards of conduct generally, and increase the risks for clients and to client money.

2. Your introduction to the consultation sets out the background against which this review is being undertaken. In particular, you cite the following justifications for the review:

   a) The current accounts rules have not changed significantly for many years. They are prescriptive and restrictive, and focussed on ensuring that all firms handle money in the same way.

b) The length and complexity of the current Accounts Rules make it difficult for new entrants to the market to understand what is required of them as well as consumers to understand what to expect when a firm handles their money.

c) Many firms find themselves in technical breach of the Accounts Rules in circumstances where there are no real risks to client money.

With reference to (a), this makes the presumption that prescription and restrictions on how client money can be handled, and consistency in the way different firms handle it, is inherently a bad thing. There are certainly provisions within the current Accounts Rules which are unnecessarily detailed, and thus prescriptive and restrictive for no good reason, which could be dispensed with. But overall we believe the consistency and certainty which the rules impose are a positive thing in connection with the protection of client money. Given the risk of misuse and/or loss associated with client money, you present no evidence that the current rules generally are disproportionate, inconsistent, opaque, or untargeted.

With reference to (b), much of the perceived "complexity" arises from the manner in which the rules are written and the technical terminology used, which is in parts difficult to interpret, rather than arising from its length per-se or the scope and detail of the provisions therein. We agree that a rewrite which rationalises the Rules is needed, and that certain provisions can be safely removed, but caution against discarding helpful provisions which contribute clarity and certainty for the sole purpose of achieving brevity or simplicity.

We accept that the current Accounts Rules are not easy to follow for anyone coming to them for the first time. We do not however believe that the majority of established firms or practitioners have any significant difficulty in understanding nor in applying the current Rules, and many welcome the detail contained in them (see above). We question whether the Accounts Rules have the purpose of explaining to consumers what to expect when a firm handles their money, or can be expected to properly fulfil this purpose. This need can be better met through other means, and should not be allowed to subvert the review.

With reference to (c), no evidence is presented to support your argument that the small number of qualified accountants' reports which lead to any regulatory action is evidence that the Rules are too complicated, or that they are not focussed on the risk. The concerns about the reporting of immaterial technical breaches was addressed in phase 2 of the review of the Accounts Rules, implemented in November 2015, when accountants were given more discretion to exercise judgement as to the materiality of breaches when preparing reports. It is too early to assess whether or not this has been effective in reducing the number of reports which are qualified for reason of immaterial technical breaches only.

Answers to Specific Consultation Questions

1. Do you consider that the draft Accounts Rules (Annex 1.1) are clearer and simpler to understand and easier to comply with?

As discussed above, we do not support the contention that the length of the Accounts Rules in itself an issue, nor do we agree that making them shorter will in itself render them clearer and simpler to understand, and thus easier to comply with. Nor do we accept the premise that the current Rules, nor the consistency of approach they promote, are unnecessarily prescriptive or restrictive, or otherwise inappropriate in connection with the handling of client money.

We agree that the draft Accounts Rules are easier to read, but are concerned some useful provisions have been needlessly discarded and that the flexibility introduced could give rise to unforeseen ambiguities and problems in practice, as explained in this response.

2. Do you agree with our proposals for a change in the definition of client money? In particular do you have any comments on the draft definition of client money as set out in the draft Rule 2.1?

a) General

The CLLS member firms all employ experienced cashiering professionals to manage compliance with the Accounts Rules. For such experts, the decision to dispense with the current detailed descriptions and the definitions of office money and office account will not be of particular concern. That said, professionals in some firms have expressed a preference for retaining the current very clear descriptions and definitions.

We are however concerned that the lack of certainty in the drafting of the new definition will challenge firms who do not employ experienced professions and, in particular, will make it more difficult for new entrants to the market to interpret and apply the new Rules, and understand what is required of them to achieve compliance.

b) "Payments for your fees"

We see the revision to the definition of "client money", to exclude payments on account of fees, as problematic when read in conjunction with the prohibition on mixing client and office money (draft Rule 4.1). The draft Rules allow firms to treat money held on account of fees as office money. While this may bring some of the benefits the SRA is seeking, there does not appear to be any good argument for depriving clients of the extra protection that holding the funds in client account brings, or otherwise differentiating this money from any other held on behalf of a client.

There is a clear distinction between an "agreed fee", which is by definition both fixed and payable to the solicitor irrespective of whether the transaction completes or the service is otherwise rendered, and an "on account" payment (irrespective of whether or not this fee is "fixed") which is payable to the solicitor only on completion of the transaction or delivery of the contracted service. Holding money on account of fees in client account clearly ensures that the money is properly protected and reflects current expectations of solicitors and their clients.

In paragraph 24 of the consultation, you argue that treating payments on account of fees as client money "may encourage or normalise the business practice of requiring consumers to pay in advance for services and before the costs have been calculated. The impact of this may be to increase the amount of money in client account in the first place and potential risks to consumers if that money is lost". We cannot see merit in this argument. It seems far more likely that allowing this money to be deposited in the firm's account, and thus available to fund the solicitors business, will normalise the business practice referred to and poses an obvious and direct risk to clients.

Although it may not happen frequently, CLLS member firms will on occasion seek to take security on account of costs from new clients or clients about whom there are credit concerns. The amounts held may be substantial and it is to the mutual benefit of both the client (who will not wish those sums to be sitting in an office account without any protection from the firm's creditors) and the firm (who will wish to have the security that holding money on account brings) to be able to hold that money in client account. Clients are likely to be reluctant to provide funds if the firm cannot hold the

money in client account and, where the firm regards this as essential in order to mitigate its own financial risks, this could lead to difficulties in those clients accessing legal services.

The revised definition of client money will also necessitate systems and process change, which has an associated cost for firms. All of the proprietary legal accounting systems are designed to handle client money as defined by the current Accounts Rules, and changes would be necessary to identify, manage and report on the new categories of office credits occasioned by the revise definition. There would also be an administrative burden in monitoring these office credits, and in ensuring that the money is moved to client account or returned to the client should the purpose for which it was received fail to crystallise. This duplicates existing processes for managing residual client account balances, of which such surplus funds currently form a part.

The consultation also fails to consider the potential tax implications of receiving payments on account into the firms office account. We are concerned that receiving these payments in advance of a supply of services would trigger a VAT tax point, and accelerate the point at which tax must be paid over to the HMRC before the services have been delivered and the income can be properly recognised.

We would therefore recommend that payments deposited on account of costs yet to be incurred should be defined as client money unless the client agrees otherwise (re draft Rule 2.2(b)). It would then be open to the firm to make it clear in their request for monies on account, or state in their standard terms and conditions (clearly communicated to the client), that monies on account would not be held in client account. It would remain open to firms to choose to offer the client the benefit that holding money on account of costs in client account brings. The protection a firm offers for money held on account should then become a matter that clients can take into account when selecting a firm, allowing firms to differentiate themselves from competitors, and increasing choice. Understanding the implications could, however, be a stretch for un-sophisticated consumers.

c) "Payments to third parties for which you are liable"

The drafting causes us concern because the underlying intention is not clear.

We can see administrative benefit for firms in being able to deposit funds for all billed disbursements into the firm's account, removing the current distinction between those disbursements which the firm has already paid and those which are still outstanding. Assuming this is the intention, we suggest that the first paragraph of draft Rule 2.1 should be amended to read "relating to legal services delivered by you to a client excluding payments to third parties in respect of expenses or professional disbursements which the firm has billed to the client".

If the SRA is intentionally drawing a hard line between unpaid professional disbursements for which the Firm is liable and those for which the client is liable, such a distinction would be impossible to operate in practice. When engaging third parties on behalf of clients, it is common practice for firms to expressly exclude liability and this approach would therefore introduce a requirement for the accounts function to assess in each case, at the point of receipt of funds, the extent to which it is the firm or the client that is legally "liable" to the third party. If this is the change the SRA intends to effect, we do not support it.

3. **Do you have any views on the use of credit cards to pay for legal services? If you are a firm, do you accept credit card payments? If not, why not? If you are a consumer, do you use a credit card to pay for legal services? If not, why not?**

   We have no views on the use of credit cards to pay for legal services.

4. **Do you consider it appropriate that only client money (as defined in draft Rule 2.1) should be held in a client account?**

   We share your view that the principle in the current Accounts Rules that only client money can be held in client account, subject to some very limited exceptions, should continue.

   Subject to our comments re payments on account and disbursements in response to consultation question 2, we believe that the definition of "client money" in draft rule 2.1 is appropriate. In particular, we consider that defining client money by reference to "legal services delivered by you" here, and in draft rule 3.3, has removed the ambiguity found in rule 14.5 of the current Accounts Rules regarding what may or may not constitute the provision of a banking facility.

   We are nevertheless concerned that no express allowance is made for situations whereby office money is inadvertently deposited in client account, which would give rise to a new category of technical breaches in circumstances where there is no real risk to client money. Rule 17 of the current Accounts Rules contains provisions which allow office money to be deposited in client account providing it is transferred out within 14 days. To avoid these technical breaches occurring, a similar provision is needed in the draft Accounts Rules which allows office money to be deposited in client account subject to it being transferred out "promptly".

   What amounts to "promptly", in this context and otherwise where this term is used the draft Accounts Rules, should be for the firm itself to decide having regard to the SRA Principles and Outcome 7.2 of the SRA Code of Conduct (or equivalent provision in any revised Code).

5. **Do you agree with our proposal that mixed monies can be paid into client or business account as long as the funds are then allocated promptly to the correct account? In particular do you have any *(comments on)* the new draft Rule 4.2 (see Annex 1.1)?**

   We would welcome a relaxation which allows, exceptionally, for client money to be paid into office account without it automatically giving rise to a breach.

   In principle, we would also support the proposal that mixed receipts can be paid into either of client or office account at the discretion of the firm involved. We nevertheless recognise that this approach exposes clients to a new risk which they do not face under the current Rules. On balance we believe that mixed payments should properly be paid into client account, as now, subject to an alternative arrangement being agreed with the client or third party for whom the money is held, as set out in draft rule 2.2(b).

6. **Having regard to our proposed definition of client money, do you agree that we can safely dispense with the specific Accounts Rules relating to payments from the Legal Aid Agency (LAA)?**

   LAA funding is not a material consideration for the CLLS member firms. We have no view on whether or not the specific Accounts Rules related to payments from the LAA can be safely dispensed with.

7. **Do you agree with our approach to allowing TPMAs as an alternative to holding money in a client account?**

   Our position on the use of TMPAs is unchanged from that set out our response to the consultation entitled "SRA's Regulatory Reform Programme", dated 9 June 2015. We have no objection in principle to the use of TMPAs. Our member firms are nevertheless firmly in favour of retaining client accounts as the primary means of managing client money.

   We note that the definition of TMPA requires that the account is held with an FCA regulated institution. This approach addresses concerns we identified previously, and as such appears to be a proportionate and appropriate response to the risks.

8. **If not, can you identify any specific risks or impacts of allowing TPMA that might inform our impact assessment?**

   Not applicable (note response to consultation question 9 below).

9. **Do you consider it appropriate for TPMAs to be used for transactional monies – particularly in relation to conveyancing? Or should the use of TPMA be restricted to certain areas of law? If so, why?**

   Subject to adequate safeguards and controls being in place, we cannot identify any compelling reason why the use of TPMA should be restricted only to certain areas of law. There may be practical reasons why TPMA might not be a viable alternative to client account, in conveyancing transactions where speed of transfer is important for example, but firms should have the discretion to make their own decision on which solution best serves its business needs.

10. **Do you have any views on whether we need to retain the requirement to have a published interest policy?**

    Rule 8.8 in the draft SRA Code of Conduct for Solicitor, RELs and RFLs (which is also currently being consulted on) contains an obligation to ensure publicity regarding the "circumstances in which interest is payable by or to a client" is accurate or not misleading. We note that there is no equivalent obligation imposed on firms, in either of the draft SRA Code of Conduct for Firms or in the draft Accounts Rules.

    In practice, interest policy will be under the control of firms and not individual practitioners. As such it will be necessary for firms to have a clear policy on interest before individuals can fulfil their personal obligation as above. For this reason, we believe that the requirement on firms to have a published interest policy is necessary, and should be retained.

11. **Do you have any comments on the draft Accounts Rules, either as a whole or in relation to specific Accounts Rules?**

    a) <u>Overarching purpose of the Rules</u>

       Rules 1.1 and 1.2 of the current SRA Accounts Rule set our clearly the purpose of those rules, and the key obligations regulated individuals have in connection with holding and receiving client money. This has historically been a very helpful entry point to understanding what practitioners must deliver to achieve compliance.

       Nothing in the draft SRA Accounts Rules conveys these clear messages. We would recommend that this information is reproduced in the new Rules.

    b) <u>Implementation and transitional provisions</u>

Consideration must be given to minimise the impact of any changes on firms, and allow for a smooth transaction from the current SRA Accounts Rule to the new regime.

If the definition of client money as set out in draft Rule 2.1 is implemented, relief must be given for amounts currently held as client money under the old Rules which is no longer client money as defined by the new Rules. The new Rules should allow for this money to remain in client account until the purpose for which it is held is exhausted, or specify a reasonable timeframe within which the funds should be moved before any breach arises.

To minimise the impact of the changes on business operations, we would suggest that firms be given discretion to decide when they transition from the old to the new Accounts Rules. The choice would be between the date the new Rules come into force or at a date which coincides with the firm's next financial year end.

c) Rule 1: Application section

Rule 6.1 of the current SRA Accounts Rules extended the Principals' responsibility for compliance with the Rules to the COFA of the firm (whether a manager or non-manager). Rule 1.2 of the draft Accounts Rules contains the same provision.

This is out with the statutory responsibilities of the COFA (HOFA) contained in s.92 of the Legal Services Act; the post holder "must take all reasonable steps to ensure compliance", but is not responsible for compliance per-se. This extension of the COFA's role gold plates the legislation, and the opportunity should be taken to remove this unnecessary regulatory burden on the post holder, if the COFA role is retained.

d) Rule 2: Client money

We agree with the concept expressed in Rule 2.3 of the Draft Accounts Rules, which we assume to mean that client money should be available to be paid at the direction of the client, but can see a problem. Modern AML and sanctions regulation means that no bank or law firm can necessarily make money available "on demand" to a client. As the draft rule currently stands each firm will therefore need to enter written agreements with clients for every client account transaction explaining the position, pursuant to draft rule 2.1(b), which will not benefit clients or firms.

The rule would be better phrased as "You ensure that client money is held in an account from which money can be withdrawn without notice unless you agree an alternative arrangement in writing with your client, or third party for whom the money is held".

e) Rule 6.1: Duty to correct breaches upon discovery

Rule 7.2 of the current SRA Accounts Rules make clears it that it is the person causing the breach and the principals of a firm who have a duty to correct it. Rule 6.1 of the draft Accounts Rules simply refers to "you" as having responsibility for correcting any breach. Read in conjunction with draft Rule 1.1, it is not clear as to who has this obligation. It could be interpreted to be an obligation of any and all employees, whether or not they were personally responsible for the breach and, by virtue of draft Rule 1.2, it is also possible that this obligation could extend to the COFA.

Draft Rule 6.1 should expressly state that it is the principals of the firm, and the person responsible for the breach, who are personally responsible for correcting it, and no one else.

f) Rule 8.1: Client accounting systems and controls

As currently drafted, Rule 8.1 of the draft Accounts Rules does not specifically oblige firms to record client and office transactions separately on the client or office side of the client ledger account respectively. We would suggest the following amendments to the drafting of this rule:

8.1 keep and maintain accurate, contemporaneous and chronological records to:-

(a) provide details of all money received and paid from all client accounts and show a running balance of all money held in those accounts;

(b) record in client ledger accounts identified by the client name and an appropriate description of the matter to which they relate:

i. all receipts and payments which are client money on the client side of the client ledger account;

ii. all receipts and payments which are not client money and bills of costs including transactions through your ***firm***'s business accounts on the office side of the client ledger account;

(c) provide a client account cashbook showing a running total of all client funds.

g) Rule 9: Operation of Joint accounts & Rule 10: Operation of a Client's own account

We note that the draft Rules incorporates an obligation to reconcile joint accounts and client's own accounts "at least every 5 weeks". Rules 9 and 10 of the Current Accounts Rules do not contain equivalent obligations. We have no objection to this change in principle, but the consultation does not explain the harm to clients or to client money arising from operation of the current rules which justifies the administrative burden arising from these new obligations.

h) Rule 11: Third Party Managed Accounts

We are concerned with the drafting of this Rule. Clients have always been able to establish escrow accounts with third parties to deal with transaction payments where that suits the parties. Firms may often be involved in the arrangements, for example advising the client on the terms and helping to set them up, but that should not of itself bring the SRA Accounts Rules into play.

The drafting should be clarified to make it clear that the SRA Accounts rules are only applicable where the TPMA is in the name of the law firm, and the law firm has operational or management control over the TPMA.

i) Rule 12: Obtaining and delivery of accountants' reports

Rule 35 of the current SRA Accounts Rules sets out the rights and duties of the reporting accountant which must be included in the post holder's letter of engagement. These include some important safeguards which have not been reproduced in Rule 12 of the draft SRA Accounts Rules.

As a minimum, we would recommend that accountants are given an express obligation to notify the SRA if they qualify a report. We would expect all CLLS member firms to comply with the obligation to deliver a qualified report to the SRA, but failing to impose any form of obligation on accountants removes a very simple and effective

check. Without this control, the SRA may not know that a firm is in breach of the Accounts Rules or the requirement to deliver a report until it is required to intervene in that firm for some other reason.

j) Rules 5.1(c), 12.8 and 12.10

These draft Rules give the SRA the power to regulate via the back door without proper consultation and scrutiny. Each enables the SRA to prescribe detailed rules or circumstances with what appears to be the sole objective of keeping the Accounts Rules short, rather than assisting either clients or firms with clarity or a reduced regulatory burden.

If a matter needs to be dealt with it should be addressed within the Accounts Rules themselves. For example, provisions dealing with small residual balances, informing clients of the amount of client money still held and the reason for retention, terms with accountants and the form of accountants' reports should all be properly drafted, consulted on and included in the Accounts Rules.

12. Are there other areas relating to the Accounts Rules that should be included in the toolkit for firms through guidance or case studies? If yes, please provide further details.

Whilst recognising that guidance and case studies can be of value, on balance, we are not in favour of the SRA developing guidance or case studies in this particular context, which we see as additional regulation "by the back door".

It is important that the Accounts Rules are self-contained, and in themselves competent to address the risks associated with handling client money. If the SRA harbours concerns that they cannot achieve this objective without the support of guidance and case studies, then the rationale for this review is brought into question, and the Accounts Rules need to be expanded sufficiently to resolve these concerns and fulfil its stated purpose. There is also a danger that issuing such guidance and/or case studies would have the practical effect of making the new Accounts Rules "long, confusing and complicated" which would defeat the SRA's stated aim of attempting to simplify it in the first place.

If the SRA does produce guidance or case studies, we think it should consult on these, whether formally or informally with stakeholder groups, before they are issued.

13. Do you agree with our assessment of the consumer impacts in Annex 1.4? Do you have any information to inform our understanding of these risks further?

The majority of CLLS member firms' clients will not be able to avail themselves of the alternative protections or redress referred to in your consumer protection analysis. They will not have access to Legal Ombudsman, the Compensation Fund or want to pay with credit card, and the amounts held may exceed the relevant limits of protection these offer by an order of magnitude.

14. Is there any information, data or evidence that you can provide or direct us towards that will assist us in finalising our impact assessment?

No.

Yours faithfully

THE CITY OF LONDON LAW SOCIETY

Professional Rules and Regulation Committee

Individuals and firms represented on this Committee are as follows:

Sarah de Gay (Slaughter and May, Chair)

Tracey Butcher (Mayer Brown International LLP)

Roger Butterworth (Bird & Bird LLP)

Raymond Cohen (Linklaters LLP)

Sonya Foulds (Freshfields Bruckhaus Deringer LLP)

Annette Fritze-Shanks (Allen & Overy LLP)

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