ICAEW REPRESENTATION 139/16

Looking to the Future: Accounts Rules Review

ICAEW welcomes the opportunity to comment on the *Looking to the future: Accounts Rules Review* published by Solicitors Regulation Authority on 1 June 2016, a copy of which is available from this link.

This response of 20 September 2016 has been prepared on behalf of ICAEW by the Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,100 members drawn from practising firms and organisations of all sizes in the private and public sectors.

This ICAEW response reflects consultation with the ICAEW Solicitors Group. The Solicitors Group Committee is made up of experts who work in a financial and management capacity within law firms and accountants in practice who specialise in advising law firms. The committee benefits from working relationships with other bodies and interested parties in the legal environment. The special interest group provides support to members including newsletters, events and networking opportunities available through icaew.com/solicitors

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MAJOR POINTS

Support for a review of the Accounts Rules and removal of unnecessary prescription

1. We welcome the SRA's review of its Accounts Rules. The Accounts Rules have not changed significantly for a number of years and a comprehensive review has been overdue. We are generally supportive of a move to a more principles-based set of requirements for keeping client money safe, though are very mindful of the challenges that this brings, as outlined in our response below.

2. We agree that some of the existing Accounts Rules are overly prescriptive and complex and therefore welcome the removal of the some of the prescription which previously has added little to protecting client money.

Not convinced by SRA motivations for change or that the perceived objectives will be achieved by these proposals

3. The key motivations for these proposed changes appear to be a desire to reduce the cost of legal services and to ease entry into the legal services market for new providers. Firstly, we are not convinced that these are appropriate motivations for seeking these changes to the Accounts Rules and, secondly, do not believe that these objectives in any event would be met by the proposed changes.

4. We are not convinced by the argument that 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. In any regulated market new entrants should be expected to get to grips with new technical issues and the need to protect client monies should outweigh any concerns about the length of the Accounts Rules. Clients don't need to know (and generally won't want to know) about the details of the Accounts Rules. Their primary concern will be that there are rigorous rules in place to protect their monies.

5. We recently met with SRA representatives and noted a desire through these proposed changes to give law firms greater opportunities to improve their working capital which in turn was seen as a method to encourage new entrants into the sector. While we accept that law firms inevitably will have working capital challenges to deal with, we don't consider this to be a suitable justification for these proposed changes. Indeed, consumers would expect that these monies would be allocated to the specific work they have engaged the solicitor to do and not to be pooled together, for example, to reduce an overdraft balance. As explained in this response an effective commercial lending market already exists to assist the funding of viable law firm businesses in respect of working capital. Forcing this funding on the consumers, who often will be vulnerable individuals, is not a desirable outcome in respect of protecting clients' interests or providing them with access to justice.

Question the SRA's approach to the review

6. We would question the SRA's approach to its review. The starting point in this review seems to have been the existing Accounts Rules and which of these rules can be simplified or cut. Yet we would expect a comprehensive review of this kind to begin with considering and articulating what the SRA's objectives are, would include an assessment of what the risks are to not meeting these objectives and exactly where they lie and then principles would be developed to specifically safeguard against these identified risks.

7. There is no evidence in the consultation paper that such a detailed analysis has been performed. While the consultation paper quotes statistics on regulatory action to suggest that the Accounts Rules are too complicated and are not focused on the key risks to client money, it doesn't elaborate on what these specific risks are. Without evidence to support what the key

risks are and where they lie, consumers may well question the SRA's objectives and whether the level of client protection available to them has therefore been reduced. We therefore believe that the SRA needs to make a clearer public interest case for these proposed changes.

8. In order to achieve its objectives the SRA should consider setting out clearly what it believes the risks to client money to be and then require firms to assess those risks as they are applicable to the firm, and to document their assessment of the risks and their response to those risks. This would then underpin the Accounts Rules and individual firms' compliance with them. For example, the FCA is very clear that the overriding purpose of its client money and client asset rules is to allow orderly and timely return of client money and assets in the event of firm failure. Therefore their rules focus on segregation, record keeping and the suitability of third parties with whom client money and assets are held, whether these are banks or other third parties.

A need for clear and specific guidance

9. While one justification for the proposed changes appears to be to reduce barriers to entry for new law firms, a move to more principles-based requirements may have the opposite effect in that law firms may find the new rules even more challenging to apply. They may be unclear about what exactly is expected of them and what controls and processes to put in place. Many may simply not have the resources or skills to develop the systems needed to support the proposed new rules.

10. A move to more principles-based requirements may lead to an increase in the cost of legal services as firms get to grips with developing their own approach to managing client money, and in turn this may lead to inconsistencies in interpretation and application. For instance, the proposed rules make several references to 'promptly' and 'appropriately' and inevitably law firms and their Reporting Accountants will need guidance on how they should interpret these, particularly as what might be deemed 'prompt' for one rule might not be considered the same for another. If the SRA is to introduce these new Accounts Rules, it is of vital importance, therefore, that it develops very clear and concise guidance to support law firms and their Reporting Accountants in applying them.

11. The Reporting Accountant's work (and therefore cost) is likely to increase in situations where law firms instigate bespoke systems for management of client monies. The existing Accounts Rules provide for more of a consistent approach across the legal sector which can help to deliver economies of scale in terms of undertaking such assignments. It is possible such increases could be mitigated if the SRA acknowledges, in so far as is possible, that an approach where law firms continue to implement and apply the 2011 version of the rules would be acceptable – as it is highly likely that many law firms will seek to make minimal changes to their existing arrangements.

12. There is also likely to be significantly more scope for disagreement between law firms and Reporting Accountants over the application of the proposed new rules, given the lack of framework for the Accountant's Report at the moment, that only qualified Accountant's Reports are required to be sent to the SRA and the proposal to remove the requirements of the Reporting Accountant's work from the proposed Accounts Rules. Reporting Accountants will need benchmarks that they can refer to in order to justify their decisions.

Risks to consumer protection and access to justice from proposed changes to the definition of client money

13. We do not believe that the change in definition of client money provides any benefit in terms of reducing the cost of legal services or encouraging new providers to enter the legal market – indeed, it is likely that this redefinition will lead to an increased financial failure rate in law firms which will restrict the availability of legal advice and access to justice and increase the cost of legal services.

14. As some firms would now fall outside of a requirement for an Accountant's Report (as they no longer have client money under the proposed definition), it is difficult to see how the SRA would know about and be able to intervene in time in a law firm before a client has suffered a financial loss. Unlike many other Regulators, the SRA does not specifically monitor the financial strength of law firms regulated by them or seek financial information on a regular basis.

15. There is an important public interest issue here which goes beyond a desire to simplify the Accounts Rules for law firms and that could undermine the trust the public places in the legal profession. We believe that the proposed new definition poses a number of significant risks, including an increased risk to the consumer, in particular, the more vulnerable members of society. One of the arguments put forward to support the protection of client funds following this redefinition is through the protections afforded to clients by using credit cards to secure payment to law firms for their services. We believe this provides limited protection or benefit to consumers.

16. The SRA may argue that these proposals simply put law firms on a similar commercial footing to other service providers, including accountants. However, we believe that there is a strong rationale for why legal services should be treated differently from the protection afforded to consumers of other services.

17. The protections that should be provided to consumers of legal services must take into account the nature of the 'product' / 'service' consumers are accessing and the circumstances under which they do so. As with deemed basic human rights to education and healthcare in the UK, access to legal services and, in effect, access to justice is a key attribute that underpins our society. Most individuals accessing legal services in the UK do so with limited knowledge. In many cases they will do so under distress or duress and they will do so out of a basic essential need to live.

18. This isn't the case for the purchase of many other products or services, which to a significant extent are discretionary and not essential to preserve basis wellbeing. The difference is clearly illustrated by looking at the types of legal services provided. These include services covering domestic violence and abuse, crime and protection of victims of crime, the protection of children and parental rights, medical negligence, immigration and property services that ensure people have accommodation. These are essential services that consumers have to make to preserve their wellbeing as human beings.

19. Protecting client funds in these circumstances represents a fundamental element of the protection that a Regulator to this sector must provide in order to ensure trust is maintained between providers of these services and consumers so that services, and ultimately justice, can be accessed with confidence. There is, however, a significant risk that the proposed redefinition of client money may damage the trust consumers have in the legal market and, in turn, limit access to legal services and justice.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Do you consider that the draft Accounts Rules (Annex 1.1) are clearer and simpler to understand and easier to comply with?

20. While we acknowledge a desire to have simpler rules that are easier for law firms to comply with, the key question for the SRA here should be whether the proposed new Accounts Rules as drafted meet the SRA's objectives and safeguard against the risks that it has identified to client monies.

21. The Accounts Rules underpin the integrity surrounding a solicitors' management of client money when they are entrusted by their client to hold funds in connection with a legal matter. They also act as a pivotal framework to assist the SRA in discharging two of its key objectives which are:

1) Protection of the consumer; and
2) Upholding the law.

22. The primary focus when considering any potential changes to the Accounts Rules should therefore be to consider the impact they might have on these underlying objectives.

23. The key motivations for these proposed changes, as outlined in the consultation paper and in discussions with the SRA, appear to be:-

- Reducing the cost of legal services; and
- Easing entry of new providers into the legal services market.

24. We are firstly uncertain whether these are appropriate motivations for seeking changes to the rules and secondly, and more fundamentally, we do not believe that the proposed changes will be effective in achieving either of these objectives. Instead, we believe that these changes could damage the intended purpose of the rules in securing the underlying objectives set out in paragraph 21 above.

25. In terms of whether the proposed new Accounts Rules are clearer and simpler to understand and comply with, there are elements of simplification within the proposed rules which we believe will be beneficial to law firms in that certain aspects of the current rules were unnecessarily prescriptive. However, while the proposed rules are shorter and less prescriptive than the existing rules, this does not, of itself, make them clearer, simpler or easier to comply with.

26. The proposed new Accounts Rules are more outcomes focused and while we are generally supportive of a move to a more principles-based set of requirements for keeping client money safe we recognise that this brings significant practical challenges for the SRA and for the majority of law firms.

27. The guidance that the SRA is intending to give to support these proposed rules has not been published and so it is difficult to give a comprehensive assessment of how they would be applied in practice. Without clear and specific guidance, we believe that there are likely to be more inconsistencies in interpretation and application, as well as more disagreements with the Reporting Accountant.

28. We anticipate that many law firms may find the proposed Accounts Rules more difficult to comply with as they simply do not have the internal resources and skill sets to develop the systems that would be needed to support the proposed new rules. They have previously relied on their regulator to provide the supporting framework to assist them in protecting client money. Introducing the proposed re-definition of client money will be difficult for many firms because this, in itself, will require them to develop some new procedures and approaches for the management of receipt of monies from clients in the future.

29. There is an assumption in the consultation that the degree of detail in the existing Accounts Rules is currently problematic for firms. However, in our view many law firms are likely to continue to want to use the existing rules as a framework to operate within, potentially only making minor changes on the less practical areas such as for specific timeframes attached to particular rules.

30. We also believe that the proposed Accounts Rules are likely over time to increase the cost of legal services for a wide range of reasons including:
- Costs of internal management and operational skills required in law firms;
- Costs of developing their own approach to managing client money; and
- Regulatory costs will increase in various ways.

31. The SRA's approach taken to this review seems to have been based on an assessment of which existing Accounts Rules can be cut or simplified. However, we would have expected to see a more comprehensive review which firstly considered and articulated the SRA objectives, then provided an assessment of the risks to not meeting these objectives and where they lie and finally set out principles that would safeguard against these risks, supported by detailed guidance. The consultation does not include this.

Q2: 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?

32. We have significant concerns surrounding the proposed change in definition of client money. We believe a primary driver for this proposed change is to remove from scope a large element of client funds which are currently afforded protection in order to remove a range of law firms from the scope of holding client money. While we acknowledge that there may be a reduction in the number of firms holding client money as a result of such a change we do not believe this, in itself, is a justifiable reason to reduce the protection to such consumers where they are providing funds to law firms and it simply reflects a reduction in regulation.

33. There is an important public interest issue for the SRA to consider here which could impact on the trust the public places in the legal profession and which goes beyond a desire to simplify the Accounts Rules for law firms.

34. As noted in our response to question 1, we do not believe that the perceived objectives of reducing the cost to legal services and increasing the ability and ease for new entrants to join the market place will be achieved by the proposed changes. In contrast we believe these proposals could have the opposite effect in the medium term.

35. As it currently stands, law firm clients have the protection offered by holding money in a client account and we believe that if changes are to be made to the definition of client money, the SRA needs to make a clear public interest case for why these changes are needed, which includes a more detailed analysis in the consultation of what the risks are, where they arise and how these will be safeguarded under the new rules.

36. The new definition of client money specifically excludes payments for solicitor's fees and payments to third parties for which the solicitor is or will become liable to settle. We believe that there are a number of significant risks from this change in definition, including an increased risk to the consumer, in particular, the more vulnerable members of society, as illustrated in the examples below.

Example 1 - Criminal trial with barrister's fees paid on account

37. In this scenario a client pays the law firm their life savings for their barrister's fees upfront to fund a complex legal case where LAA funding is not available. The amount involved is significant and the client concerned is unable to pay using a credit card because they are unable to access such credit and in any event the amounts required are too high to fund in this way.

38. Under the new definition of client money the law firm could take these monies to the office account. The law firm then uses these monies to pay other expenses, for example, wages, drawings and does not pay the barrister to provide the advice to the client. The law firm becomes insolvent and it has not paid the barrister's fees. As a result the vulnerable client will have lost their funds. The legal ombudsman may be able to provide some compensation but in this case it is going to be insufficient to meet the barrister's fees.

39. The client concerned will have been denied access to justice as a result of having entrusted their monies to a law firm which has used them to fund the law firm's own business rather than

meeting the liability of the barrister's fees for which the monies were provided. The client will also have suffered considerable financial loss.

Example 2 - Clinical negligence case with money paid in advance for medical experts reports

40. In this scenario a client cannot secure funding for essential medical tests and reports to support a negligence case. LAA funding is also not available in any form. The client takes personal borrowing to support the costs of legal advice and expert fees in the interim.

41. Instead of using those monies for their intended purpose the law firm uses them to fund operation expenses and drawings by the owners in the interim. The law firm subsequently becomes insolvent and the vulnerable client loses their funds. The legal ombudsman may be able to provide some compensation but in this case it would be insufficient to meet all the costs concerned.

42. It is not a responsibility of the SRA to support failing law firms. However the SRA's objectives do include protecting the consumer and promoting the upholding of the law. By default this requires the availability of legal advice to consumers, both in terms of a sufficient range of legal service providers in the market place and also sufficient public trust to use them.

43. In our opinion it is likely that the re-definition of client money will result in an increased financial failure rate of law firms in the short to medium term which will restrict the availability of legal advice to consumers, increase the cost of such services and damage the confidence consumers have in approaching law firms for legal support. This will impact on the ability of the SRA to meet its core objectives.

44. As some firms will fall outside of the requirement to maintain a client account and to have an Accountant's Report, it is unclear how the SRA will know about, and be in a position to intervene in, these firms before it is too late and the client (and other third parties) suffer a financial loss. Unlike a number of other Regulators, the SRA does not specifically monitor the financial strength of law firms regulated by them or seek any financial information on a periodic basis.

45. We know that a large number of law firm failures arise not from a lack of profitability but as a result of bad cash management – in short, profits are drawn before they are earned leaving insufficient cash to run the business.

46. On first glance one might assume that making it easier for law firms to take their costs at an earlier date from the client account would improve this position. The reality, in our view, is that this will simply encourage firms to draw out cash for personal use at an earlier point. While one can argue that this should not happen; in reality current and past behaviours in law firms strongly suggest this is likely to be the case. This would then lead to more law firm financial failures but with the added complication that more clients (consumers) will be financially affected by such failures than is currently the case. In our view it is the more vulnerable members of society that will be affected in such situations.

47. The SRA may counter argue that the firm would know that the monies are for fees and disbursements and should be used for this purpose and that placing the money into a client account as currently would be the case does not, in itself, prevent firms from knowingly or dishonestly using these funds. However, the proposed changes in the rules mean that the SRA's key principle of 'only using client money for its intended purpose' is only covered in proposed rule 5, which only deals with money held in a client account. As this is not client money under the new rules the principle would not seem to attach to it.

48. The point we want to illustrate here is that this is not merely about dishonesty, which clearly no set of rules could totally overcome. One needs to consider the vast majority of honest law firms

who genuinely aim to protect their client's money. In this context we need to remember that the office account is one big pool of funds which will have lots of transactions going in and out. It will now be a significant burden (and cost) under the new rules for law firms to implement systems that manage the office account and clearly confirm to them at any point in time what actually 'belongs' to the firm. For many firms such systems will not work and this ultimately will result in inappropriate spending of 'client' money. The only way around this would be to set up a separate office account for payments on account which would rather defeat the objective here in operational terms.

49. In terms of the protection afforded by the Legal Ombudsman and the use of credit cards, we believe in both cases this provides only limited protection for consumers. We provide more comments on the use of credit cards in response to question 3. In respect of redress via the legal ombudsman this has limited scope. It is also naïve to assume this will have no impact on the future cost of legal services and it also ignores the practical hardship this will bring on vulnerable consumers having to follow these processes through to secure the return of their funds. Making a claim under any of the options highlighted in the consultation paper is likely to be an onerous task for the public and they may find it difficult to make a successful claim in the absence of access to files and time records, let alone understanding the work done and being able to prove how much of the service they have had as compared to the payment on account made, i.e. the value of their net claim to be made. Clients would have little chance of knowing whether any settlement offered is right or wrong without engaging another professional to review the relevant information and advise them and thus at more cost.

50. Further consideration is also required in our view as to whether the proposed definition of client money would be a correct legal interpretation. A number of solicitors have expressed concern to our members that, in their opinion, money on account of fees and money on account of disbursements which the solicitor will incur on behalf of a client actually represent monies held on trust by the solicitor. For the solicitor to take those funds and use them for anything other than delivering those services (internal or external) for that specific client could be a breach of trust under law.

51. There is merit in considering what the view would be of a member of the public providing money on account to a law firm to pay for disbursements and whether they would have any realistic expectation that in the meantime such monies may be used to fund the drawings of the partners in that law firm.

52. There is currently an active and effective market mechanism for law firms to access funding for working capital including:
    - Partner / owner capital;
    - External bank funding – direct or indirect; and
    - Third party investment (following the Legal Services Act).

53. We have seen no evidence that a lack of funding to the legal sector inhibits either the entry of new suppliers to the market or increases the cost of legal services. The change in the definition of client money will encourage law firms to use client money in place of this commercially available funding.

54. In returning to the apparent motivations for these proposed changes, we believe it is unlikely that this proposed change in definition will reduce the cost of legal services. In contrast this is likely to lead to an increase in financial failures in law firms in the medium term which will increase the cost of regulation and interventions and eventually flow through to consumer pricing over time. Providing legal services is a comparatively complex activity and so the attraction of an 'easier' definition of client money is unlikely to be a compelling reason to attract any new competition to the legal sector.

55. The proposed new definition of client money is fundamental to the proposed rule changes and we have given further commentary on this issue in our response to question 11 below.

Q3: 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?

56. One of the arguments put forward to support the protection of client funds following the redefinition of client monies is through the protections afforded to clients by using credit cards to secure payment to law firms for their services.

57. In our view this provides limited protection or benefit to clients for the following reasons:

Access to legal services and justice

58. A credit card facility will not be available to a large proportion of the population. Often those individuals in society who have the most restrictive access to legal services will equally not be able to secure personal credit to use a credit card. Proposing a system that provides protection to clients using credit cards will produce a two-tier system within society giving those who can secure a credit line access to legal services with fair protection and those in society who cannot and this seems inequitable.

59. At a time when the restriction on the availability of funding, and limited access to justice, is already highly visible through the restriction in LAA funding in recent years, we believe this will present another further damaging restriction to access to justice and legal services for the most vulnerable in society.

60. If the legal sector is provided with the ability to access payments on account at an earlier point as office money it is highly likely that over time firms will naturally become policy driven to extract payment from clients for their work at an earlier point.

61. In effect it will become normal practice for clients of law firms to have to pay for services at an earlier point in the service cycle. While this may be seen as favourable to the law firms in terms of providing them with earlier access to working capital (which incidentally is of course available to them already in the commercial lending market from banks) in our view this will also lead to a large part of the consumer society being excluded from accessing law firms services.

Frequency of credit card use

62. Our members have indicated that some law firms will accept payment by both debit and credit card however the use of credit card in their experience is relatively low because:-
    - In many cases the credit limits available are low compared to the cost of legal services;
    - The interest rates available to credit card holders are prohibitive; certainly for securing legal services; and
    - The charges that credit card providers make to law firms will actually increase the cost of accessing legal services.

Ability to accept credit card payments

63. The costs to a law firm business of accepting credit card payments are significant. This will be a disproportionate cost to smaller law firms and is likely to result in a further contraction in the size of this part of the legal sector.

64. Smaller law firms often provide a practical option for more vulnerable members of society to access legal services. Increased requirements for firms to provide payment by credit card is likely to have the effect of pushing up the cost of legal services to a section of the population who are least able to access the market already.

Medium term costs to law firm

65. The concept of using a credit cards to give protection to clients is that ultimately the credit card provider would suffer the risk of non-payment (eg, if law firms fail to deliver their services and the client makes a claim on their credit card)

66. It is unlikely that using credit cards would provide any reduction to the cost of legal services because credit card providers would naturally build such costs into the charges they levy on law firms, for example, credit card providers will charge law firms for the services and, in addition, if credit card providers suffer losses on advances to law firms (eg, because the law firm becomes insolvent) then, over time, the cost to law firms of accessing credit card receipt will also increase.

67. If not done so already, we would strongly recommend that the SRA seek input directly from credit card providers as they may have some concerns to raise here.

Credit limits

68. Even if a client does have access to a credit card, it is unlikely that they will have a sufficient level of credit to cover any significant law firm services or disbursements. If we consider the types of cases where there are perhaps greater risks to the client of the law firm holding their money on the office account eg, where specialist third party services such as barristers and experts are involved or where simply the legal fees will be high; using a credit may simply just not be possible.

Encourages debt in society

69. Suggesting that legal services are best purchased by credit card to afford protection to clients promotes the use of debt in society. We are not convinced that legal services are an appropriate product to be purchasing on credit and there is also a risk that such actions encourage parts of society who are often in distress and least able to afford debt to take on a further burden.

70. The use of a credit card might not be a significant issue to those wanting to cover the costs of a conveyance transaction or even undertaking a small commercial transaction as these people entering these transactions are more likely to have the resources to take such risks. More detailed consideration is needed, however, for those most vulnerable in society who may be forced into a need to purchase legal services and in turn to use credit to achieve this as a result of changing attitudes from law firms.

Q4: Do you consider it appropriate that only client money (as defined in draft Rule 2.1) should be held in a client account?

71. At present mixed funds (office and client) can be paid into the client account, providing office funds are transferred within 14 days. This approach provides practical flexibility simply because in many cases the firm will be receiving amounts from clients or third parties which are a mixture of office and client money. The requirement to transfer office money out in itself provides both good discipline to ensure a law firm is keeping control over what money belongs to who and more importantly it helps to protect against teeming and lading (hiding shortfalls) in client money more generally. So at some point the firm needs to make an assessment of what money is client and office and reallocate appropriately.

72. We believe that greater protection for the consumer is provided here if mixed monies continue to be paid in the first instance into a client account with a requirement to promptly transfer monies to the office account that are not client money.

73. In our view the current requirement for transfers of all office monies to be made to the client account within 14 days is restrictive. A better approach would be to rely on the term ‘promptly’ here but for the SRA to provide some practical scenario-based guidance. Reporting Accountants will often find breaches of rules around the timescales in these areas which present no risk to client funds and no indication of a poor control system.

74. An ancillary point to raise here is how law firms account for VAT on receipts from their clients. Under VAT rules there is a requirement for the firm to account for VAT to HMRC at the 'VAT point'. It is likely that the change in definition of client money proposed will mean that the VAT point will be earlier for law firms on their services. So when they receive the payment on account, which would now be defined as office money, they would need to account to HMRC for VAT on this receipt even though they may not have technically raised an invoice to the client at this point. There will be similar considerations to take into account for amounts received from clients in respect of disbursements and this will be more complicated. The main points on the VAT front to make are:
    - There will be administrative costs and challenges to law firms to manage an earlier VAT point;
    - Any cash benefit from receiving monies from clients at an earlier point, for operational purposes, will be reduced as a result of 20% of those monies often going straight to H M Revenue & Customs; and
    - Software systems will in many cases need to be amended in law firms to manage the change; it is likely that significant costs will arise to firms as a result.

75. All of the above will add to the cost of legal services in the short to medium term.

Q5: 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 the new draft Rule 4.2 (see Annex 1.1)?

76. While this change to the current position provides greater choice to law firms they would still need to allocate funds to the correct account in a reasonable timeframe.

77. The existing approach of requiring mixed payments to be paid into the client account in the first instance affords the greatest protection to consumers in a range of situations.

78. We are not sure that providing law firms with a choice in this situation is beneficial to either the firm or the consumer. In our view such a provision would have no impact on reducing the cost of legal services, providing access to justice or encouraging new entrants to the sector; it would simply reduce consumer protection.

Q6: 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)?

79. The proposed new definition of client money would in effect make the specific provisions in respect of LAA largely redundant because the LAA provisions allowed payments on account of disbursements and fees to be treated as office money – which of course is what the new definition of client money more generally is now proposing.

80. As previously highlighted we do not agree that the proposed definition of client money is appropriate but if this approach is adopted then we agree that the specific LAA provisions could be removed from the rules and it would be a matter for the LAA to manage their requirements over the control of their funds with firms directly through contract terms.

81. In this context the experience of law firms in managing LAA payments on account in their office account is an interesting indicator of the problems that are likely to arise if law firms are allowed to mix payments on account with other office monies.

82. Our members have indicated that they have seen a range of examples in law firms in recent years where firms have suffered financial difficulty and sometimes failure as a result of losing control over the payments on account received from the LAA. While this has not been helped by the lack of information available from the LAA to confirm amounts outstanding at times, the main point is that law firms have frequently relied on the funding from the LAA to fund their

business. When demands for recoupment have then been issued by the LAA there has been a number of outcomes:

- Heightened risks to consumers over their legal matters;
- Other client funds held were exposed to higher risks; and
- The LAA (and the public) have suffered losses as a result of recoupments not being secured.

83. The experience of firms managing LAA funds as advance payments is therefore an early indicator of the challenges the SRA and the legal sector more generally are likely to face in the future if the proposed changes to the definition of client money is applied.

Q7: Do you agree with our approach to allowing TPMAs as an alternative to holding money in a client account?

84. The SRA is keen to provide the legal sector with choice and we understand the rationale for this is a combination of allowing the free market to operate and to attract new legal providers to the market but also to reduce the cost of legal services and increase access to justice.

85. In theory, therefore, the concept of allowing TPMAs would seem to promote these objectives. However the SRA also has a role in protecting the interests of consumers and needs to consider what, if any, real benefit to consumers the option of using TPMAs will provide.

86. By introducing TPMAs as an alternative to holding a client account, it appears that the SRA would pass its responsibility for the regulation of client monies received by law firms across to the FCA through reliance on the FCA regulatory regime. This regime in itself is in our view very different to the existing SRA protections.

87. When we met with SRA representatives in July 2016, we flagged a number of concerns about the use of TPMAs as an alternative to holding money in a client account. We strongly believe that the SRA needs to consider to what extent the selection and monitoring of TPMA providers is equivalent to the requirements of the SRA's Accounts Rules regime and what steps need to be taken to ensure that consumers fully understand the differences between the two approaches, about how their money will be treated as well as what legal protection will be afforded by the TPMA arrangement as compared to a law firm holding money in a client account.

88. Given the requirements in the proposed Accounts Rules we do not see how these proposals would be commercially viable for law firms or, indeed, would be in the interests of consumers.

89. In terms of detailed comments on the draft wording of the proposed new rule please see our response to question 11.

Q8: If not, can you identify any specific risks or impacts of allowing TPMA that might inform our impact assessment?

90. See our response to question 7 above.

Q9: 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?

91. It seems unlikely that TPMAs will practically work in situations where transactional work is concerned. Of course there is a possibility that a new product may be developed over time that achieves this but none has been developed outside the legal sector to date and there are clear applications where such a product could be used already.

92. It is difficult to see how the SRA could prescribe what types of work could be undertaken through TPMAs if they are going to approve their use more generally.

93. For a large number of law firms this would lead to a situation where they need two systems operating; commercially it is hard to see how such firms would want to operate in this way. So where they undertake transactional work we would think they would be less likely to consider using TPMAs. This has been our members' experience to date in discussing the matter with law firms.

Q10: Do you have any views on whether we need to retain the requirement to have a published interest policy?

94. It is important to note that at present law firms do not pay their clients interest on client funds they pay an amount 'in lieu' of interest in certain circumstances. The difference historically has been important due to the taxation and administration that would be associated if real interest was paid to clients rather than compensation for lost interest they would have otherwise received on their funds.

95. The proposed rule 7.2 can be interpreted to mean that law firms can mitigate their obligation to pay any such compensation to clients. For example a standard written agreement with every client saying that the firm 'does not account for payments in lieu of interest on client funds held and that such amounts are taken into account when agreeing the charges applied for services' could easily achieve this. Potentially such a clause could even be included in a standard client care letter providing the client's attention is drawn to this fact at the start of the matter. While there are background requirements in relation to respective bargaining positions in such arrangements if this is taken in the context of being covered in part by the overall fee and in conjunction with the proposed rule changes here we believe law firms could justify such an approach.

96. Our members suggest that the administration for law firms of these payments in lieu of interest is cumbersome and disproportionate in most cases to the value provided to the client. Our members also indicate that in their experience interest payment policies are not effectively and consistently applied in some law firms. So removing the obligation to pay a sum in lieu of interest is likely to provide an opportunity to reduce the cost of legal services by reducing the administrative burden for law firms and the cost of regulation.

97. In terms of an interest policy, we understand that many law firms continue to apply an interest policy which is similar to that contained in the Solicitors Accounts Rules 1998.

98. It would, however, be important for the client care letter to clearly state at the outset whether the firm has a policy of making payments in lieu of interest on client funds held because some law firms may hold significant amounts of client monies for significant periods for clients.

Q11: Do you have any comments on the draft Accounts Rules, either as a whole or in relation to specific Accounts Rules?

99. We believe that a number of the proposed Accounts Rules will need to be supported with clear and concise guidance and we would question whether it is really appropriate for some of the existing requirements to be moved to guidance (which will be non-mandatory) rather than in the Accounts Rules. See our more detailed comments on individual rules below.

100. **Rule 2: Client money.** It has been highlighted in discussions with the SRA that they see an 'inconsistency' in the existing rules regarding the treatment of money for an 'agreed fee' (office monies even where the work has not been done and/or the bill hasn't been raised) and 'payments on account of costs' (client monies). Until recently the SRAs definition of an agreed fee (the 'cast iron' nature of the 'fixed' and the 'not dependent on completion' elements) had meant that much of what might be thought of commercially as an agreed fee didn't fall into this category. The impression from recent discussions with the SRA is that in fact 'agreed fee' is more widely drawn and the definition is met in many more instances than expected. It is not

clear to us at this stage what has prompted this change in view over time and in our opinion it is not what the current rules (rule 17.5) actually mean.

101. Either way there doesn't seem to be any consumer protection rationale behind defining 'money on account' of work where the fee element is not 'fully fixed' and the work not yet done or billed as non-client money. All the attendant concerns regarding masking working capital issues in law firms provide a more compelling argument for this money to remain client money.

102. Further concerns arise where the 'disbursement' element of those costs is also non-client money without a clear definition of what the SRA mean by using the term 'liable'. The proposed rules only refer to a distinction between those where legally the client is personally liable (for example, SDLT, HMLR registration fees) versus those the firm will be liable for (by virtue of them instructing the professional, obtaining the search on their own account).

103. The SRA has focused on the different treatment of professional and non-professional disbursements and hence that on receipt the money for these professional disbursements will be non-client monies. The SRA explains that the extent to which this will be the case will mean quite a large number of firms may well no longer hold any client money at all but we would query this and what is meant by the term 'liable'.

104. In respect of professional disbursements we would presume that the point at which the firm becomes 'liable' for them (in terms of both timing and amount) is when the professional has finished their work (or that stage of their work) and presumably billed the law firm. If this is the intention under the new rules then it would seem all the changes are doing is requiring monies received for those unpaid (but fully incurred) professional disbursements to be banked into a business account; when the firm actually become liable for them (i.e. the professional has billed the law firm). This is currently allowed with a requirement to deal with the payment within 48 hours.

105. However, it is not clear from the proposed rules and recent comments from the SRA would suggest that it is actually proposing that all money on account (including fees and disbursements – again excluding SDLT etc.) would be non-client. It seems likely that a large amount of such money received in this way is based upon estimates rather than known amounts.

106. Rule 2.2(b) could be interpreted to mean that a blanket comment in client care letters would enable the firm to hold all money outside a client account. We think it is highly likely firms will interpret the rule as drafted in this way.

107. Rule 2.3 will most likely be interpreted to mean that a blanket comment in client care letters would enable the firm to hold client money in an account which is not repayable on demand. It is also unclear from the rule whether the requirement here is per client (as the rule works currently) or whether it would be acceptable for a firm to transfer a 'hard core' of the client balance they never really use to a longer term deposit that is for a fixed term as long as they could justify that any monies likely to be needed are available 'on demand'.

108. Given the problems that have arisen over many years with firms not managing residual balances and because the rules prior to the introduction of rules 14.3 and 14.4 were not prescriptive, the rule written in 2.4 looks to be encouraging more of the same problems to arise. It has taken a long time to get this subject into the Accounts Rules and it seems a backward step to now remove it and make the issue less transparent, particularly if the firm is able to make the decision, based on guidance but with no rule setting a de-minimis limit.

109. **Rule 3: Client Account.** Rule 3.3 on banking facilities appears to be less robust than the existing rule and in our view makes it easier for law firms to fall into the position where they are providing such services. We have already raised concerns on this with SRA representatives to clarify whether this was the SRA's intention here. If it is the intention then we are not clear on

the rationale for changing the wording. We note that there will be guidance in this area but are conscious that the SRA has been highlighting the seriousness of this problem for some time now so it would seem odd to make the requirements less robust here.

110. **Rule 4: Client money must be kept separate.** The interaction of this rule with the proposed definition of client money (excluding payments for the firm's fees and payments to third parties for which the firm is liable) is confusing. This rule appears to deal with situations where the client has provided a round sum payment to the law firm (or where the law firm have received funds from a third party) and where fees have not been outlined or agreed with the client.

111. It is not clear why in rule 4.3 (b) payments on account of fees rendered could not be made from a client account i.e. as well as 'specific sum identified in the bill" which is what is stated in the rule. It is illogical not to be able to use money in Client Account to pay part of an agreed fee invoice i.e. either the amount due on the fee or if lower and available the sum in Client Account for that client. In general rule 4.3(b) seems to be at odds with the SRAs view about money on account being non-client (office) when those funds held are 'non-specific'.

112. There is merit in our view of rule 4 requiring the consent of the client for the transfer of monies to settle the invoices as this leaves the client with control over their money and removes the existing challenges of understanding what element of the client funds represents money earmarked for the settlement of fees.

113. **Rule 5: Withdrawals from client account.** We would suggest the reference to withdraw in this rule be replaced with pay, as in reality no firm ever 'withdraws' money e.g. in cash, as most payments will be made by electronic transfers or BACS through the banking system. Rule 5.1 (b) needs to include joint as well as sole instruction(s) to make payments.

114. **Rule 7: Pay interest where appropriate.** We have given considerable comment on the requirement to make payments in lieu of interest earlier in this response. Rule 7.2 as currently drafted appears to provide law firms with an easy way to simply opt out of paying these amounts. On balance we consider that this has benefits but it is unlikely to be what the SRA envisages in this rule. If the rule remains then it should be clear that the amount being paid is a sum in lieu of interest.

115. **Rule 8: Client accounting systems and controls.** We would suggest that rule 8.1 (b) should also require a current balance on the ledger. Rule 8.1 (c) looks similar to (a) and appears dated and irrelevant to firms given the use of computerised systems. We would suggest that rule 8.1 (c) be combined with rule 8.1 (a). In rule 8.3 client account reconciliations should include building societies as well as banks and there is no requirement within this to investigate or resolve reconciliation differences but unless this is done client money could be at risk. Rule 8.4 requires law firms to keep a central record of bills or other written notifications of costs but this would appear unnecessary in a computerised system as information will be available for retrieval on a search and most of this would need to be maintained for VAT and HMRC purposes anyway, as well as allocated to the client file (manual or electronic).

116. **Rule 9: Operation of joint accounts** and **Rule 10: Operation of a client's own account.** We are unclear why there appears to be a new reconciliation requirement introduced in rule 9.1 and 10.1 for joint accounts and client's own accounts. Under the existing rules, reconciliations are not currently required for either of these.

117. **Rule 11: Third party managed accounts.** Rule 11.1(b) and (c) and 11.2 make it uncommercial for law firms to even contemplate TPMAs. Rule 11.1(b) and (c) effectively means the risk of client money management ultimately remains with the firm even though it is outsourced. The wording is widely drafted, for example 'ensure your client's money is safe'. Rule 11.2 requires the firm to check every single transaction that the TPMA undertakes. This represents a duplication of work as they will need to maintain their own accounting and client

ledger systems to do this and all they will have achieved is that the physical transactions will be organised elsewhere. While appearing to give law firms the option of using TPMAs, law firms are unlikely to see any commercial benefit from doing so based on how rule 11 is currently drafted.

118. **Rule 12: Obtaining and delivery of accountants' reports**. We note that the requirements in rule 43A are not contained with the proposed Accounts Rules and in the absence of the guidance on this, it is difficult to comment on this proposed rule. We note that the terms of engagement and whistleblowing responsibilities are specifically excluded from rule 12. The SRA since 2015 require Reporting Accountants to form opinions based on professional judgement. Whistleblowing rights and protections are an important aspect which underpins the ability of the Reporting Accountant to undertake their work under this regime and we would have expected to see these in the rule. We also believe that rule 12 should be clearer about who can provide an Accountant's Report and the manner in which it is prescribed.

Q12: 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.

119. Please see answers to question 11. We also believe that further guidance should be provided in relation to reconciliation differences.

120. Annex 1.5 on initial reading appears to largely be a list of all the old rules now being excluded from the proposed new rules and being represented as guidance instead. The proposed guidance areas appear wide ranging and we would be pleased to input further into these areas and widen them as required in the future.

121. It is important in our view for the SRA to accept that many firms will, however, seek to make minimal changes to their existing operational arrangements if the rules are changed. To this extent many law firms are likely to adopt the approach of retain the 'old rules' as they were previously acceptable and make only minor changes where they have to or where there are clear practical benefits and no risk to client funds (e.g. specific timeframes for compliance with the 'old' rules might be relaxed). It would be helpful for the SRA to make comment on this expected approach by firms in these circumstances and provide positive guidance and assurance (or otherwise) to those firms on how they might operate under any new regime.

Q13: 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?

122. Annex 1.4 suggests that the scenarios presented may only arise in 'extreme' cases. We think this is unrealistic and that the problems highlighted in this annex will be common place in law firms under the proposed rules and, in particular, the proposed definition of client money.

123. The consumer protection analysis in our opinion appears relatively brief and we believe there are far great repercussions for consumers, particularly those who are vulnerable consumers and those who already find it difficult to access legal services in the current market place. In our view a much deeper analysis of the possible repercussions of the proposed changes is required.

124. The annex focuses largely on how clients might suffer if law firms take the clients' money and do not use it to deliver the service or the third party product but instead use those monies to fund the law firms (or indeed the drawings of the owners). As outlined earlier in this response we do not believe the protections afforded by the Legal Ombudsman or the use of credit cards are appropriate responses in such situations.

125. There is a strong risk that public confidence in the provision of legal services could be greatly damaged with these proposed changes. While the SRA should not be responsible for maintaining the reputation of the legal sector it cannot ignore the fact that damage to its

reputation will, by default, discourage consumers from taking legal advice, thereby inhibiting access to justice.

126. An expected outcome, in our opinion, which will arise from the proposed changes, is that the general integrity over the management of client funds will deteriorate over time. There will be a higher volume of law firm financial failures, higher profile client financial losses and adverse client experiences. All of this will lead to increased regulatory and operating costs for the sector as a whole and will damage access to legal advice by the general public.

127. These overarching risks and impacts on the consumer are not in our view fully explored in Annex 1.4.

128. We also think that Annex 1.4 could usefully have included a scenario where monies have been misappropriated from a TPMA, highlighting what actions consumers would be able to take to recover their monies.

Q14: Is there any information, data or evidence that you can provide or direct us towards that will assist us in finalising our impact assessment?

129. We understand that many law firm financial failures have arisen not as a result of lack of profits but as a result of overdrawing by the owners before profits are collected. The proposed change in the definition of client funds is likely, as a result of human nature, to result in an increased propensity for law firms to extract profits at an earlier date. Previous discussions and work with the interventions teams supports the above assertions.

130. With the proposed change in the definition of client money it is likely that in the short term the level of interventions and financial failures will actually fall – because during this period some firms will in effect be using client money to support their on-going drawings or to support a failing business.

131. In the longer term, however, we expect the number of interventions will increase considerably and at this point the challenge which will exist for the SRA will not only be to manage the large number of on-going client matters from a legal perspective but also to handle much more significant shortages of client funds (eg, disbursements not met and fees paid in advance where no service has been provided). Over time this will lead to a combination of higher regulatory costs (intervention and indemnity fund calls) and other costs associated with law firms such and PII premiums, costs of credit from banks and cost for the provision of credit card facilities to law firms from providers. All of these costs will ultimately flow back and push up the cost of legal services.

132. The commercial lending market continues to provide an active and important part in funding law firm businesses (eg, providing working capital funding). This is an arm's length service and, in effect, a law firm has to demonstrate its own ability to successfully run a business to secure such funding. The change in the definition of client money, will in effect, place the clients in the position of providing the same working capital funding to the law firm in the future in a non-discretionary way. There is no external scrutiny – where banks provide the funding for working capital they continue to ensure the business is viable; clients providing their money on account have no ability to do this. The client will not actually appreciate that this is happening. For example, if a client pays a law firm £5,000 for a medical report disbursement to be prepared at the start of a matter they would not realistically anticipate that in the meantime their money may be used to pay the salaries of the firm or the partners drawings.

133. Overall there appears to be a view within the SRA that helping firms reduce working capital by using client funds at an earlier point will both encourage new entrants to the sector and reduce the cost of legal services. In our view it will do neither and is not a sound basis for changes to rules intended to protect client money.