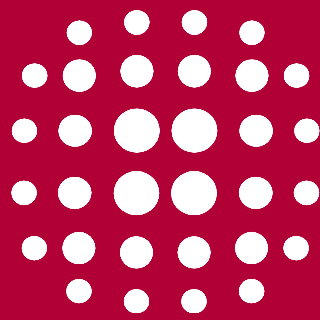

Our response to consultation: Accounts Rules review

June 2017

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Looking to the future: Accounts Rules review

Executive summary

1. Setting and maintaining clear, high professional standards is fundamental to public trust and confidence in solicitors and law firms.

2. Our Looking to the future (Lttf) regulatory reform programme emphasises those high standards, while allowing individuals and firms more flexibility in how they organise themselves to meet those standards. This is likely to lead to greater variety of business models and more choice for the public and small businesses.

3. Alongside our proposals to create a shorter, sharper, clearer Handbook, with a revised set of principles and codes, we also consulted on updating our Account Rules.

4. Our consultation on the third and final phase of the review of the Accounts Rules ran from 1 June to 21 September 2016.[1] We are grateful to all of those that took the time to respond to the consultation. In this document we provide a summary of key themes from the responses to the consultation and set out our response to the issues raised. We then provide a question by question summary of responses. We have also published all those responses where the respondent gave us permission to do so.

Why change is needed

5. The current Accounts Rules set out in minute detail how firms should run their accounting systems. This creates logistical problems for some firms to be compliant and makes it difficult for many firms to comply at all. Such complexity often ends up resulting in technical breaches. It drives confusion, cost and non compliance rather than good practice.

6. For example, a sole practitioner in a rural area has to drive to the bank several times a week to make sure cheques from clients are deposited within 48 hours of receipt as required by our rules. While sometimes this may be necessary, there is little flexibility for the solicitor to decide what is best in the circumstances and best for their clients overall.

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[1] Phase one came into effect in October 2014 and made minor changes to the format of the annual accountant's report that firms are required to obtain and introduced an exemption for certain firms from the need to obtain that report. Phase two came into effect in November 2015 and encouraged reporting accountants to apply an outcomes-based approach to assessing compliance, with a focus on client money. We also extended the exemption from the obligation to obtain an accountant's report to firms with an average client account balance of no more than £10,000 and a maximum balance of no more than £250,000 over the accounting period.

7. It is our view that we need to put more trust in solicitors professional judgement. We do not need pages and pages of prescriptive rules for a solicitor or firms to do the right thing and maintain professional standards.

8. For instance, all good solicitors know that they should not steal money belonging to their clients. We do not think they need - or benefit - from more than 40 pages of detailed Accounts Rules setting out how to avoid stealing.

Our proposals

9. The consultation proposed broad changes to the Accounts Rules by significantly shortening them and focusing on their core purpose of keeping client money safe. Our proposals can be summarised into three strands:

   - Simplification of the Accounts Rules by removing prescriptive rules and requirements, and reducing duplication with other sections of the Handbook.
   - Changing the definition of client money.
   - Providing an alternative to holding client money by allowing firms to use Third Party Managed Accounts (TPMA).

Consultation responses

10. There was broad support for our aim of simplifying the Accounts Rules. There was a diverse range of views on the detail of how we do that.

11. We received by far the greatest number of comments on the proposed definition of client money, both through formal responses and during our engagement activities. The change in definition was intended to simplify what is currently a very complex rule. It would also allow firms in some circumstances to choose not to operate a client account. For these firms, this would mean less regulatory burden and potential professional indemnity insurance (PII) savings.

12. We highlighted in the consultation that we anticipated this proposal, of all of the proposals in the Accounts Rules consultation, would have the biggest impact on firms. We sought specific feedback on the impacts for both firms and the public.

13. We are pleased that so many stakeholders offered their views on this issue throughout our consultation process. We were clearly told that the consequence of the proposed change to the definition of client money would be that all firms would have to change their systems and incur significant costs in doing so. This would include the many firms that did not feel that they, or their clients, would benefit from this change. While many firms have been positive about the proposed changes to the definition, the majority wish to continue to operate as they do now.

14. The aim of our wider reform programme is to provide solicitors and firms with flexibility to adopt new business models, but not to promote particular practices or require firms to change current practices if they do not want to. Having considered the feedback provided, we have revised our position in a

way that allows simplification and greater flexibility while minimising the burden on firms that do not want to change.

Responding to feedback and our decision

15. We have therefore revised the definition to:

- define the client money that must be held in client account
- define client money to include all monies paid in advance for fees and disbursements[2] before a bill has been issued
- provide an exemption so that where the only client money that is received is advance payments for fees and unpaid disbursements for which the firm is liable, that money does not have to be held in client account. This means that firms that only handle these types of client money do not need to operate a client account.

16. Our proposals for simplification have otherwise been well received, subject to some small changes in response to the feedback received (as explained in the Question by question analysis section) and the changes relating to the definition, the rules remain largely unchanged from the version upon which we consulted. We believe they will offer clear standards that the public can expect to be met while providing significant flexibility to firms.

17. However, we have made some changes to the rules as follows:

- We have introduced the term "regulated services" in the rules and glossary to clarify that the rules apply in relation to these.
- We have removed the reference to the firm's Compliance Officer for Finance and Administration (COFA) being jointly and severally liable with the firm's managers, for compliance (see rule 1.2). This emphasises the responsibility of the firm's managers for ensuring that the requirements in the Accounts Rules are embedded within the firm's systems. The COFAs responsibilities remain unchanged from the current position, and are set out separately in the new Code of Conduct for firms.
- We have introduced a rule exempting payments from the Legal Aid Agency (LAA) from being held in the client account.
- We have removed the requirement for all firms that cease to hold client money to obtain a final accountant's report. We have instead introduced a rule that allows us to require a report if we think it is necessary in order to ensure that client money has been properly dealt with when a firm closes down a client account.

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[2] Now defined as "any cost of expenses paid or to be paid to a third party on behalf of the client or trust (including any VAT element) save for office expenses such as postage of courier fees".

18. We are also proceeding with our proposals to allow solicitors to use TPMAs. This will provide additional flexibility through an alternative to running a client account. We will not impose any restrictions on the types of monies firms can hold in a TPMA, this will be for each firm to determine what is appropriate for them in discussion with their client. The current range of products is limited and we are keen to see more developed. Certainty as to the regulatory position is likely to encourage innovation in this section of the market, offering greater choice to firms and their clients.

19. We are developing a toolkit to support implementation of the new rules. We will work with stakeholders to develop the material, which will be launched well in advance of the changes. The new rules will come into force no earlier than autumn 2018, alongside the rest of the Handbook changes.

Key themes and our response

Section 1: A new definition of client money and client liability

Our consultation proposals

20. In the consultation we proposed a change to the definition of client money in order to simplify the current complex rule and allow firms to accept money for fees and professional disbursements (for which the firm is liable) as their own. Our proposal was to reduce the scope of what is considered client money (ie money that must be held separately in client account) by excluding these categories from the definition of client money. Under this proposal, monies held in relation to transactions (for example, completion funds or settlement monies) and payments for which the client is liable (such as payments to be made to HMRC) would be considered client money.

21. We asked respondents if they agreed with our proposals to change the definition of client money and for comments on our draft rule.

22. Under our current rules, the only type of advance fee a firm can take as its own are "agreed fees" – defined as those which cannot be varied up or down and most importantly are payable in any event. This is in effect much narrower than a "fixed fee" – which, if required in advance, would have to be paid by the firm into the client account until the work had been billed. For example, a client may agree that a fixed fee for conveyancing services is payable if the transaction does not complete. This would be an agreed fee. If, for example, only a percentage of the fee would be due, this would not be an agreed fee and therefore falls within our current definition of client money. Feedback we received during the consultation suggested the distinction between agreed and fixed fees is often misunderstood. This supports our view that the approach to fees in the current definition is overly complex.

23. We also sought views from respondents on whether greater flexibility was needed as to what could be paid into client account. For example, clients of a litigation firm making regular payments on account might request they continue to be paid into client account, even though these payments are no longer defined as client money (to ensure protection through separation of monies in the client account). Firms may also choose to do so as a matter of

policy. Where respondents commented on this option, the majority stated that only client money (as defined) should be held in client account and that firms should not have the flexibility to choose to pay other types of money into client account. We also received some feedback from firms that would want the flexibility to choose so that they could continue with their current systems and processes.

24. Most respondents voiced strong objections to our proposal to exclude fees and professional disbursements from the definition of client money. Respondents have clearly told us that the consequence of the proposed change to the definition of client money would be that all firms would have to change their systems and incur significant costs in doing so. This would impose a cost of compliance that does not exist for any of our other reforms. While many firms have been positive about the changes to the definition, the majority wish to continue to operate as they do now and feel strongly about doing so.

25. One example of this is the treatment of VAT. Currently, VAT is not payable on advance payments held in the client account until the matter is billed, as these funds do not belong to the firm. Respondents have pointed out that changing the definition of client money as proposed would mean that VAT would become payable by the firm at an earlier stage than at present. This in turn would mean that firms would need to change their accounting systems and software to accommodate earlier VAT payments.

26. Some respondents told us that firms would feel obliged continue to hold professional disbursements in a separate account in any event to meet what they considered to be trust obligations.

27. Several firms (mainly litigation firms) have commented that a restriction on holding payments on account in client account would deter their clients from making advance payments at all and significantly affect the viability of their business. It is common practice for litigation firms to require payment on account due to the risks of non-payment, in the event that the client is not happy with the outcome of the case.

28. Concerns were also raised regarding the potential reduction in consumer protection. Many respondents stated that the alternative protections (consumer credit legislation, the Legal Ombudsman (LeO) and the Compensation Fund) that we refer to in the consultation do not provide adequate safeguards for consumers. For example, some respondents stated that it is difficult to make a successful claim against a credit card provider using section 75 of the Consumer Credit Act. Others cited that consumers would be unsecured creditors in the event of insolvency. Some respondents stated the risk of theft would be increased where money was not held in the client account.

Our response

29. Having considered the points raised during the consultation, we have amended our proposal for the definition of client money in the final version of the rules to allow firms with a client account to continue to operate as they do now. We have provided some flexibility for those firms that do not wish to operate a client account by creating an exemption from doing so where the

only client money they hold is in relation to fees and disbursements relating to expenses which they have incurred on their client's behalf (such as counsel's fees). This does not enable firms to hold other types of client money (such as a house deposit or stamp duty) outside of client account. Firms that handle these categories of client money will still be required to hold the money in client account or a TPMA unless otherwise agreed with the client (as is currently permitted for all firms[3]).

30. This approach has allowed us to simplify the definition and provide greater clarity to firms, members of the public and small businesses. All fees and disbursements paid in advance are considered client money until the point at which they are billed. These payments must therefore be held in a client account, unless they are the only categories of client money held by the firm and the firm takes advantage of the exemption (in new rule 2.2).

31. For the majority of firms with a client account the new definition means that fees and disbursements paid in advance are considered client money and therefore have to be paid into client account until they are billed, as is the case now. This will mean that the majority of firms that wish to operate a client account can continue with their current accounting systems with no changes to systems and processes other than those they choose to make due to the increased flexibility in the rules.

32. There will be no need for firms operating under the exemption to comply with many of the requirements in the Accounts Rules, which are focused on the holding of client money in a client account (such as the requirement to obtain an accountants' report or to pay interest). However, such firms are still required to comply with the relevant systems and controls requirements (set out at rule 8), (for example, the requirement to obtain bank statements of all accounts run by the firm at least every five weeks and the requirement to keep a central record of all bills or other written notifications of costs). They are also required to have a COFA to ensure compliance with the relevant systems and controls requirements. The COFA must also oversee whether there is a need to have a client account, and keep this under review should the firm start to handle other categories of client money. All firms must comply with the standards in the Code of Conduct, including the requirement to act in each client's best interests and to safeguard money and assets belonging to clients.

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[3] There is a general ability in the rules for all firms to agree different arrangements with their clients so that client money can be held outside client account. This is not new. In the current rules this is rule 15.1. In the final version of the rules this is rule 2.3(c):

You ensure that client money is paid promptly into a client account unless:-

> *(c) you agree in the individual circumstances an alternative arrangement in writing with your client, or the third party for whom the money is held.*

Analysis of risk

33. The risk of theft (either by the firm or through cyber crime) exists whether money is held in a client account or not. We have paid out approximately £9m from the Compensation Fund (in the period 1 November 2013 to date) in circumstances where the claim related to a firm's failure to account for money paid on account for fees and disbursements[4]. The risk exists even with the current, high levels of prescription in the rules and the requirement for the money to be held in a client account. We do not think that detailed Accounts Rules can mitigate a risk that a solicitor will be dishonest. Nor do we accept the view expressed by some respondents that a solicitor is more likely to misappropriate money from the firm's own account.

34. The key risk of absent dishonesty lies in what happens in the event of insolvency. If, for example, a client pays £2,000 in advance for legal fees and for a medical report – under the new exemption the firm would be able to pay this money into their business account. If the firm goes into insolvency before the work is done, the money would be lost and the client treated as any other unsecured creditor. The money would not have the protection of being held in a client account. However, the client would still be able to make a claim to the Compensation Fund in these circumstances. Clients could also make a claim to the Compensation Fund in the event of theft. The protections we have in place apply regardless of whether the lost money originated from a client account or not.

35. In both cases, if the work is not completed and the firm refuses to complete the work or return the money, eligible clients would also be able to seek redress via LeO.

36. We are increasingly of the view that all firms should ensure clients are clear about the nature and basis of any advance payments they are asked to make. For example, if a client pays a fixed fee for a divorce and decides not to go ahead, are they entitled to a refund? Or, in a conveyancing transaction, what happens if the sale or purchase collapses once 85 percent of the work has been done? There are, of course, other rules and standards around transparency over costs and ensuring clients have enough information to make decisions about the options available to them.

37. Where a firm makes use of the exemption and does not operate a client account, clients should be clearly informed that the money is not being held in a client account and agree to this in the knowledge of what it means. We will be issuing guidance on this before the rules are implemented. We will also consider whether additional information should be provided on the Legal Choices website[5] to help consumers with questions to ask and things to consider when instructing a law firm.

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[4] This figure does not take into account monies that are subsequently recouped by subrogation from the Statutory Trust

[5] 'Legal Choices' is a website and social media platform jointly managed by seven legal regulators across England and Wales. It provides factual non-commercial information about lawyers and their services to members of the public. Please visit www.legalchoices.org.uk for more information

38. We have considered the comments from respondents that some experts (for example medical experts) who work on a deferred fee basis will be less likely to accept instruction from firms that do not have a client account because their payment will not be protected in the event of insolvency or an SRA intervention. This could lead to a consumer's detriment as their case might not be progressed and they might need to take a loan to pay the upfront cost of an expert.

39. If an expert is not willing to take instruction from a firm that does not operate a client account we think there are ways to work around this. One way would be for the solicitor to simply facilitate the contact between the client and the expert and for them to arrange a suitable payment method. Another way could be for the firm to find a way to assure the expert that they have the ability to pay. It would be for the firm to establish and maintain relationships with the experts they need to instruct in their clients' matters.

40. On balance, we consider that the potential advantages for consumers outweigh the limited risks. The new definition is simpler, with a clearer position on the status of all advance payments. This will make it easier for consumers to understand the basis on which they are being asked to pay money in advance. We have decided against the sort of full flexibility we sought views on in the consultation. This would have allowed firms to decide whether or not to hold payments for fees and professional disbursements in client account. While such an approach would have mitigated many of the concerns from firms with regards to the potential systems changes (they could simply choose to do so as a matter of firm policy), the regulatory position would be less clear to consumers. It might also have led to inconsistency across different clients within a firm and created practical issues for reporting accountants, or for us when we investigate and/or intervene into a firm. This view was shared by respondents to the consultation.

Legal Aid Agency payments

41. In the consultation we proposed to remove the specific rules relating to payments from the LAA. The majority of money held by a firm under a legal aid contract consists of money for fees and disbursements, so would not have been held in a client account in the version of the rules upon which we consulted. We discussed this with the LAA prior to consultation and they had no objections. The rules as proposed in the consultation did not put LAA monies at an increased level of risk.

42. We have noted that some respondents expressed concern that LAA firms often run overdrafts and work under financial pressure. It was suggested by some that the removal of the specific LAA rules could lead to firms systematically manipulating their financial position in order to stay in business.

43. It is important to remember that the Accounts Rules should not be seen in isolation. Firms have to comply with all of our rules. This means that firms and individuals must, among other things, act in their client's best interest, not act with dishonesty and ensure that matters are progressed without undue delay. These provisions apply to firms who do work under a legal aid contract the same way they do to other firms.

44. In our new rules, fees and disbursements will be held in a client account unless the firm operates under the exemption. We have therefore introduced a separate rule for LAA payments, to reflect the position (but in a far simpler way) in the Accounts Rules 2011 and the consultation proposal.

45. This new rule, 2.3(b), reads as follows:

    You ensure that client money is paid promptly into a client account unless:

    (b) the client money represents payments received from the Legal Aid Agency for your costs;

46. In effect the new LAA rules mirror the current position on LAA payments. Firms will be able to continue to take these payments into their business account. The only change from the current Accounts Rules is the removal of the rule that advanced payments for disbursements must be put back into client account if the party providing the professional services isn't paid within a specified time. The LAA has confirmed that they have no issue with the removal of this provision and they are content that the rules are workable from their perspective.

47. Removing the provision for disbursements to be held in a client account if they are not paid within a certain number of days does not mean that firms will be able to hold payments from the LAA in their business account indefinitely. If, for example, a firm does not pay an expert's fee (because the firm retains the money in their account to avoid increasing their overdraft) and thereby delays a client's matter, this would constitute a breach of our rule to make payments promptly. It is also likely that this would be a breach of our Code of Conduct.

Section 2: Simplification of the rules

48. The current Accounts Rules are extensive, prescriptive and detailed. The new rules are more proportionate – focusing on the key objective of keeping client money safe, rather than prescribing how firms should run their accounts.

49. As a consequence of the current, high levels of prescriptive detail in the Accounts Rules firms are often in technical breach of the rules, without there ever being any real threat or risk to client money. We introduced changes to the accountants' report requirements in phases one and two of our Accounts Rules review. These changes encouraged reporting accountants to apply an outcomes-based approach to assessing compliance, with a greater focus on risks to client money. When consulting on these changes, we highlighted statistics from the period of June 2012 to December 2013, where more than 50 percent of the approximately 9,000 firms that hold client money received a qualified report. Of this number, only 179 were referred for consideration for further regulatory action. This shows the extent to which firms are in "technical" breach of our rules. As we said in the consultation, this is unlikely to meet any of the tests for better regulation.

50. A majority of respondents supported our objective to simplify the rules and agreed that the proposals achieve this aim. Many respondents also welcomed the removal of the detail in the rules, stating that removing the risk of

"technical" breaches will make compliance with the rules easier. Respondents also anticipated that the new rules will improve compliance and reduce cost.

51. The Law Society confirmed that solicitors would like the rules to be simplified and are supportive of any serious attempt to reduce their regulatory burden. Solicitors have also stated that it is important to update the rules, bringing them into line with current business sectors and industries. However, they were concerned that there could be negative unintended practical consequences. This included increased bureaucracy and administrative costs for new systems and staff training arising from the proposed changes.

52. Some respondents have stated that the rules are less precise, making them more difficult to apply in practice. Others were concerned as to whether the new rules would be effective, as they leave more room for interpretation. Firms are familiar with the detailed prescriptive requirements of the existing rules and worry they may find the application of the new rules time-consuming and challenging. Many stated that, while the proposed rules are simpler and easier to understand, it is difficult to say if they will be workable in practice without seeing the guidance that we have proposed, should we go ahead with the rules.

53. A number of respondents stated that there is a risk we are perceived as trying to "regulate by the back door" by issuing guidance in areas that were previously rules. Other respondents cautioned against issuing too much guidance and case studies, as this would not achieve our objective of simplification and would rather complicate the situation for firms trying to achieve compliance with the rules.

54. A large majority have requested that we issue guidance on how firms should deal with residual balances. Other requests included case studies on different transaction areas and specific situations, such as what constitutes "promptly" in the context of the Accounts Rules (for example, guidance on when money needs to be returned promptly to a client or third party when there is no longer any proper reason to continue holding it (as set out in rule 2.5)).

Our response

55. We are pleased that a majority of respondents agreed that we have achieved a good balance in the simplification of the rules and will therefore proceed with the rules as consulted upon, subject to the small changes set out in this response and the changes related to the definition of client money.

56. We acknowledge that the new rules mean a change in approach for many firms. For instance, some respondents have suggested that the removal of prescription (for example the current timeframes of a set number of days) creates ambiguity and that this will lead to different interpretations of the rules and potential non-compliance. The new rules are intended to give firms more flexibility to decide what is best for their clients and for their business while being very clear as to the standards we expect. We expect that many firms, at least at first, will continue to operate as they do under the current rules and in doing so will remain compliant with the new Accounts Rules. For those firms that want to make changes we will be providing a range of supporting materials through our toolkit.

57. We highlight below four substantive changes we have made as a result of the consultation responses and further engagement we have done with some of our key stakeholders.

58. We have also made a small number of what are purely drafting changes to the version of rules we consulted on. These changes are simply intended to clarify the rules and not change them in any way.

Removal of COFA from rule 1.2

59. Rule 1.2 in the version of the rules we consulted on stated that the firm's managers and COFA are jointly and severally responsible for compliance by the firm, its managers and employees with the rules. Respondents suggested that this wording made the COFA directly responsible for compliance with the rules, which would place an unreasonable burden on the COFA that does not exist in the current rules.

60. Under our proposed new Code of Conduct for firms the COFA will be required to take all reasonable steps to ensure compliance with the Accounts Rules by the firm and its managers and employees (or the sole practitioner). This reflects the current position under the Authorisation Rules (current rule 8.5(e)) and, in relation to licensed bodies, section 92 of the Legal Services Act 2007.

61. The comments from respondents have persuaded us that the COFA should be removed from rule 1.2. The rule now states that:

    "The Authorised Body's managers are jointly and severally responsible for compliance by the Authorised Body, its managers and employees with the rules."

62. It is often the case that a manager in a firm will also be the COFA, but this is not always the case. We have removed reference to the COFA in rule 1.2 to emphasise that the Accounts Rules create obligations on the firm and its managers, not on the COFA. The COFAs obligations under the Code of Conduct to take all reasonable steps to ensure compliance with the Accounts Rules and report any concerns from a position of independence will still apply.

New definition of regulated services

63. In the version of the rules we consulted on we used the terminology "legal services" in relation to the services that a firm provides to a client. Some respondents commented that as there is no definition of "legal services" there was a risk that firms and the SRA interpret would this differently.

64. We have changed the wording in the final version of the rules to "regulated services" in order to ensure that this captures all of the legal and professional services regulated by the SRA. We believe that this terminology provides a clearer definition of what activities fall within the scope of the Accounts Rules and should clarify the obligations of firms.

The need for reconciliations for joint accounts - rule 9.1

65. In the rules we consulted on we introduced a requirement on firms to carry out reconciliations for joint accounts[6]. Firms are currently not required to do this. Some respondents suggested that this introduced a burden on firms and it could be difficult to comply with this obligation as the firm would not always have access to all the relevant records to perform the reconciliation.

66. We have considered the feedback from respondents and have removed the reconciliation requirement for joint accounts from the rules. The obligation to obtain statements at least every five weeks and to keep a readily accessible central record of bills and other notifications of costs still apply.

New approach to final accountants' reports

67. Under the current rules, when a firm stops holding or receiving client money we require it to obtain a final accountant's report. This has to be delivered to us whether it is a qualified report or not. These are commonly known as "cease to hold reports". The aim is to ensure that when a firm shuts down and closes its client account, we can be confident that all client money has been properly dealt with in accordance with the rules. If not, and we are alerted to risks to orderly closure or to clients, and then we can take action to control those risks – either by way of an investigation and disciplinary action or by us refusing to revoke the firm's authorisation. We may grant a waiver in line with our waiver policy from the requirement to obtain a cease to hold report on a case by case basis.

68. In the rules we consulted on we retained the requirement (rule 12.5 in the consultation). However, the current draft rule relates to the situation when the firm ceases to "hold" client money, and this is open to interpretation. Also, through engagement we have identified that the requirement is sometimes disproportionate and can put an unnecessary administrative burden and cost on firms. To take the example where a firm simply switches legal status from partnership to LLP and so transfers the money to a client account with a different name, neither the account nor firm is strictly ceasing to operate and there would not be any increased risk to client money. Our rules would however still require the firm to obtain a cease to hold report for the partnership.

69. We have therefore changed rule 12.5 to better reflect our approach to risk. We will now require firms to submit a cease to hold report when a firm shuts down and closes its client account only on a case-by-case basis, if we believe that it is necessary. We will issue guidance for the criteria and relevant risk factors we will use when making the decision to require a report to be submitted.

70. We think this approach strikes a better balance between regulatory burden and consumer protection as it reduces the burden on firms that simply change their legal status or firms that hold small amounts of client money and have a good compliance record.

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[6] A joint account is an account where a firm holds or receives money jointly with the client, another practice or another third party.

Other concerns raised by respondents

71. We have retained the approach to treatment of mixed payments set out in the consultation whereby they must be allocated to the correct account promptly (rather than within 14 days). A small minority of respondents supported this proposal. Those who objected suggested that it was an unnecessary removal of client protection and that there is a risk that firms will use client funds to manipulate their cash position.

72. Respondents have not persuaded us that this change in approach will cause significant detriment to consumers or present any increased risk to client money. If a firm were to use client money to manipulate their cash position, it is likely they would find themselves in breach of our rules. Firms will still be required to move money between accounts promptly and comply with all our other rules. This includes the requirement to act in a client's best interest, to not retain funds for longer than necessary and to act with honesty and integrity. Some respondents have queried what level of information is sufficient in order for the client to give informed consent to a different arrangement regarding the payment of interest and if it is enough to include the information in the terms and conditions.[7] This will depend on the circumstances. The client must give informed consent and it is for a firm to satisfy themselves that they have given the client the opportunity to do so. The prominence and the ease of access to the information will be important in determining this.

73. The decision to remove the requirement for firms to have a published interest policy was taken due to duplication with the new standard 8.8 in the Code of Conduct for individuals and does not comprise a change in policy. Firms are still required to have a clear interest policy in place. The requirement to have an interest policy also applies to firms through rule 7.1(b) in the Code of Conduct for firms.

74. We noted the concerns that the introduction of terms such as "promptly", "fair" and "appropriate" requires an exercise of judgment and that many will prefer the comfort of prescriptive requirements. We understand that these changes will be an adjustment for many firms that are used to the detailed and prescriptive nature of the current Accounts Rules. However, we do not think this provides sufficient justification for retaining rules which we know are often breached with no real impact on keeping client money safe.

75. In response to the comment that what is appropriate may change over time – we do not disagree. In fact, this is precisely why it is important to allow this sort of flexibility in the rules. This means that firms can fulfil their duties and meet clients' individual circumstances, rather than take certain action simply because our rules say so.

76. We will address key common scenarios in our toolkit of resources, which will be published well in advance of the rules being implemented and will be there to support compliance. It is not intended to replicate or replace rules. The focus of the toolkit will be to help guide firms to make decisions and form their

[7] Rule 7.2 states: ***You*** may by a written agreement come to a different arrangement with your client or the third party for whom the money is held as to the payment of interest but you must provide sufficient information to enable them to give informed consent.

own judgments as to what is acceptable under the new standards. We will collaborate with stakeholders and reference groups to develop the toolkit. This will include additional guidance on the new exemption provided by the definition of client money set out earlier in this document.

77. In our phase one consultation we set out our intention to review our enforcement strategy. This review built on the important work that we did through the 'Question of Trust' campaign in 2015-16, which engaged the legal profession and the public to help us to develop and confirm the most, and least, serious conduct and disciplinary matters. We will be consulting on a revised enforcement strategy later this year, alongside phase 2 of the Lttf review. Our Question of Trust work confirmed our view on the most and least serious matters, and helped us to refine our views on the factors we will take into account when making our decisions such as intent and motivation, harm and impact, vulnerability, role and seniority, and patterns of behaviour.

78. An updated enforcement strategy, aligned to a shortened Handbook and new Codes of Conduct will provide a flexible framework within which solicitors and firms can operate. We are moving away from a prescriptive compliance model. We set standards that provide a clear representation of our expectations, but we build in some flexibility as to how solicitors ought to behave to meet those standards. The revised strategy sets out a clear framework that solicitors and firms should find much easier to understand. Clarity about how seriously we view different behaviours will provide the profession (and compliance officers in particular) with a clearer idea of what constitutes a serious, reportable, breach of our regulatory arrangements.

79. We will not be providing pages of detailed guidance to support the revised enforcement strategy. We will provide some examples of 'grey areas' alongside the final strategy, as this is what solicitors have told us that they need to understand how it will work in practice.

Section 3: Third Party Managed Accounts

80. In the consultation, we proposed to allow firms to use a TPMA as an alternative to a client account. We defined TPMA as an account where a third party (a payment service provider) holds money on behalf of two or more transacting parties. In this case a third party would hold funds for a law firm and their client.

81. Under our proposals the decision to use a TPMA must be made in accordance with our requirements, but money held in a TPMA will not be subject to the standards in our Accounts Rules. Our proposal was to restrict the use of TPMAs to those operated by payment services providers that are regulated by the Financial Conduct Authority (FCA) under the Payment Services Regulations 2009. We therefore did not propose any additional requirements relating to TPMA providers.

82. Some respondents have questioned what distinguishes a TPMA from other escrow-type services. A TPMA is not a traditional escrow account. An escrow account is an account opened in the joint name of the contracting parties and the parties hold the funds jointly. By comparison, in a TPMA the money is held by the third party provider and contractual arrangements stipulate how

the monies are to be used. The money is held by the third party provider in their name, the account is not in the name of either (or both) of the contracting parties. By way of clarification therefore, our position on TPMAs does not in any way alter the use of escrow services by solicitors.

83. The draft rules allowed firms to use a TPMA if:

- The TPMA is either:
    - an authorised payment institution (API) and, as a result, has mandatory safeguarding arrangement, or
    - is a small payment institution (SPI) which has adopted voluntary safeguarding arrangements.
- The firm can demonstrate that it has suitable arrangements for the implementation, use and monitoring of TPMAs. For example, that appropriate information is provided to clients and appropriate internal controls are in place.

84. We asked respondents for their views on our approach to TPMAs and if they could identify any specific risks or impacts of allowing TPMAs.

85. In the consultation we proposed to allow TPMAs to be used for all types of client money. It would be for each firm to determine if, and how, they wanted to use a TPMA in discussion with their clients. We asked respondents if they agreed with this, or if there should be restrictions on the use of TPMAs for transactional monies, particularly in relation to conveyancing.

86. The majority of respondents stated that they had no objections to the use of TPMAs and in principle supported the introduction of these types of products. Many commented that the use of TPMA would not be a viable option for their firm, due to uncertainty surrounding timings of payment and firms being uncomfortable with the control over client funds resting with a third party. Others said that while TPMA may not be for them, it could be useful for smaller firms that do not handle large amounts of client money. A minority stated that they would wait and see what products the market develops before determining if TPMA was an option for them.

87. A number of respondents expressed concern about the use of TPMAs for transactional monies, particularly in relation to conveyancing. As this is time-sensitive work they were concerned that a TPMA may not allow for the same level of control as a traditional client account, given that the money is not controlled directly by the firm. Other respondents suggested that while there are questions about the suitability and practicality of using TPMAs for all areas of work, it should be for to each firm to determine what best suits their business, and not for us to stipulate.

88. BARCO, the Bar Council's equivalent of a TPMA, has expressed strong support for our proposal to allow TPMAs as an alternative to client account. BARCO has stated that allowing the use of TPMAs will help us achieve our regulatory objectives of promoting competition in the provision of legal services. It also said that the use of TPMA ensures there is greater protection and choice for consumers. BARCO also considers it appropriate for TPMAs to

be used for transactional monies and says it has have been successfully assisting with commercial conveyancing for some time.

89. The Law Society's response supported the introduction of TPMAs. However, it also highlighted the risk that that client protection arrangements for those using TPMAs are likely to be much more complex than those for traditional client accounts. This is because TPMA providers are regulated by the FCA and fall within the jurisdiction of the Financial Ombudsman Service (FOS), whereas comparable complaints about a solicitors' operation of a client account are the responsibility of LeO. They stated that the use of TPMAs could lead to increased consumer confusion around redress schemes and uneven client protections.

90. Other respondents raised concerns on the suitability of TPMAs being under FCA regulation, uncertainty surrounding the business structure of TPMAs and safeguards if, for example, a firm goes out of business. A query was raised as to whether eligible clients could make a claim on the Compensation Fund in these circumstances.

Our response

91. The responses support our view that use of TPMAs may be beneficial to some firms as an alternative to operating a client account. The new rules will provide greater certainty than under the current regime on the regulatory position for solicitors that want to use TPMAs, and we might therefore expect to see greater variety in the types of products available. This includes those suitable for transactional work.

92. Money held in a TPMA is not held by the solicitor or firm, but by the TPMA provider. It does not meet the definition of client money as set out in rule 2.1. This means that the provisions in the Accounts Rules relating to holding client money do not apply to monies in a TPMA.

93. Regulation by the FCA provides an appropriate level of oversight in relation to the regulation of TPMAs as financial service providers and ensures adequate consumer protection. The nature of how TPMAs are structured means that they already fall within the regulatory remit of the FCA. We would be duplicating the FCA's regulation by imposing rules relating to the functioning of TPMA's.

94. As well as making sure the TPMA is an API or SPI, solicitors will have to ensure that they comply with the standards in the Code of Conduct, including the duty to act in clients' best interests and safeguard money and assets belonging to clients. We would expect this would include an assessment of the suitability of the product in the particular circumstances and for the particular client. We would also expect that clients understand that the basis on which the money is held and that it is different to a regular client account.

95. To clarify, the solicitor will not be responsible for the monies in the TPMA, as these are held by the TPMA provider and are not under the solicitor's direct control. The solicitor will however be required to ensure that they comply with the requirements in the Accounts Rules relating to the use of TPMAs. We will not ask firms who choose to use a TPMA to report it to us. We are confident that firms that comply with our requirements will make sure that they are using a product that is appropriate and compliant with the rules.

Question by question analysis

We present here a summary of key themes from responses to the Accounts Rules consultation.

Question 1

Do you consider that the draft Accounts Rules (annex 1.1 in the Looking to the future: Accounts Rules review consultation document, June 2016) are clearer and simpler to understand and easier to comply with?

Context

The current SRA Accounts Rules 2011 have been simplified with a focus on key principles and requirements for keeping client money safe. The proposed Accounts Rules are six pages long, compared with the existing rules that are 40 pages long.

Responses

A majority of respondents agreed that the rules have been simplified. However, many stated that while the proposed rules are simpler and easier to understand, it is difficult to say if they will be workable in practice without seeing the guidance we propose should go along with the rules.

Reasons why respondents agreed included:

- Simpler rules would make it easier to comply. Firms would not run the risk of being in technical breach of the rules as the strict time limits have been removed.
- The proposed rules are simpler and easier to understand, meaning:
  - they should help increase compliance
  - they should help reduce compliance costs
  - improved simplicity could help understanding among both consumers and the profession.
- The proposed rules retain areas fundamental to making sure client money is looked after.

Reasons why respondents disagreed included:

- The proposed rules would be difficult to apply in practice as there is more room for interpretation.
- It would be more burdensome for reporting accountants to do their job as there is room for interpretation as to what constitutes a breach.
- Law firms are familiar and comfortable with the strict, rules-based requirements of the current Accounts Rules, and may find the proposed principles-based regime challenging.

- The proposed rules leave a large volume of work for firms to undertake in order to develop their own systems, something many lack the skills and resources to do.
- The proposed rules are likely to increase the cost of legal services in the short to medium term, due to the cost of developing new accounting practices and increased administration being passed on to the consumer.
- Terminology, such as "promptly, responsible, fair, appropriately", etc, is open to interpretation, and bodies such as tribunals could change their interpretation of these terms over time.

The Law Society stated that the proposed rules appear simpler. It also confirmed that it knows solicitors would like the rules to be simplified and are keen for there to be a serious attempt to reduce their regulatory burden. Members of the Law Society have expressed concerns that there could be negative unintended consequences, increased bureaucracy and administrative costs brought on by the proposed rules.

Solicitors have also stated that it is important to:

- update the rules
- bring them into line with current business sectors and industries
- make sure the rules are more user friendly.

Question 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 (see annex 1.1)?

Context

We proposed a change to the definition of client money that we consider strikes a better balance between consumer protection and regulatory burden. Reasons for our proposal include:

- Firms which currently operate a client account only to handle payment on account for fees and disbursements will have a reduced regulatory burden, as they will no longer have to operate a client account.
- Wanting to reduce the amount of money held in client account by firms.
- Incentivising new ways of working for firms by reducing the amount of prescriptive regulation.

We have proposed a reduced scope for our definition of client money. The key changes are:

- Money paid on account for fees or disbursements for which the firm is liable will no longer be considered client money.
- Removing the distinction between agreed fees and payment on account of fees (both for fixed fees and generally on account), treating all money for fees equally.

Responses

Reasons why respondents agreed with our proposal included:

- The change is better aligned to the firm running as a business in terms of cash flow and simplifies the process in terms of receiving client money.
- There is no particular reason, other than past practice, why people using legal services should be afforded more protection for payments made in advance than people using other services.
- The draft definition seems appropriate to safeguard clients while allowing firms to carry out business with integrity and without erroneously finding themselves in technical breach.
- It would be very clear what is client money and what is not, and there would be limited transfers between office and client accounts. This would assist in making sure client money is properly segregated.
- The proposed changes remove from the current definition of client money those monies which are expected to become the solicitor's money on or before completion of the matter to which they relate. This has the effect of treating payments received in advance (of services being performed) in a manner which is consistent with other businesses in the wider commercial world.

A majority of respondents disagreed with our proposed definition of client money. Reasons why respondents disagreed included:

- The change would be a significant reduction in consumer protection, which would not be offset by the benefit to the profession that the proposed rules bring.
- The proposed alternative consumer protections do not provide adequate protection for consumers.
- The proposed definition would be difficult to work with in practice and would lead to increased risks to client money.
- Firms would need to make changes to their accounting software, with attendant cost and disruption. Software providers would need time to develop systems that would work with the proposed definition.
- When receiving a payment on account of costs (which would have to be paid into business account under the proposed rules) it is likely that the firm would have to account for VAT at the point of receipt. This may cause problems as the firm is only liable to pay VAT on the fee element, not on disbursements. It will be difficult to identify the specific elements of a payment at the beginning of a matter, as firms do not know at that stage how much of a payment on account is for fees and how much is for disbursements.
- Some respondents are of the view that, under the new definition, they would hold all money they receive from clients on trust. Using that money for anything other than delivering those services for that specific client would be a breach of trust.[8]
- The Institute of Chartered Accountants in England and Wales and the City of London Law Society both stated that it is unclear what the status of money

[8] It is possible for firms to hold money on trust for clients, but this is not required by our rules. Whether money is held on trust will depend on factors such as the contractual arrangement between client and firm, and the intention of the client.

paid for disbursements would be until the point that the firm/solicitor actually incurs liability for payment.
- There is a risk that the number of firms that fail due to bad financial management will increase:
  - keeping money that a firm has not yet earned in its business account. This could increase the risk of firms unintentionally using this money to pay for other matters.
  - firms getting into the habit of drawing profits before they are earned.
- The proposal would not make it easier or cheaper for consumers to access legal services.
- The proposed rules would make it more difficult for new entrants to the market to understand what is required of them.

Some respondents commented that the proposal would have a devastating effect on experts who provide services on behalf of clients on a deferred fee basis. If the client money definition is changed as proposed, service providers would be unwilling to provide the service without upfront payment, as there would be no protection in the event of either an intervention or insolvency.

This could lead to consumers being in a worse position, as firms would need to set up funding loans for clients before instructing experts and counsel in order to pay their fees immediately. Any loans would be subject to interest not currently incurred, meaning the consumers are at best financially worse off and at worst prevented from accessing legal services.

Respondents also stated that if the rule as currently drafted goes ahead, it would be beneficial for us to set a time limit within which firms have to make the payments to third parties. This would discourage firms from keeping money that is in effect owed to third parties in their business account for a period of time (for example, to keep within agreed overdraft limits). This would then benefit the firm but not the client or third party.

Question 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, would you use a credit card to pay for legal services? If not, why not?

Context

We asked how common it is among firms to accept payment for services by credit card. Any payment made by credit card that is over £100 and under £30,000 is subject to protection under section 75 of the Consumer Credit Act 1974. This protection means that a consumer can make a claim against the credit provider for the sum paid in the event the supplier does not provide the agreed services in part or in full. If consumers are unable to pay by credit card there are other protections, such as:

- asking LeO to order the firm to provide redress

- making an application to our own Compensation Fund.

A recent FCA market study found that 60 percent of consumers have at least one credit card. We asked respondents whether they had any information regarding impacts in terms of access to credit cards among certain socio-economic groups.

Respondents

A significant number of solicitor respondents confirmed that they accepted credit card payments and do not have any strong objections against the use of credit cards to pay for legal services. Many have stated that consumers do not often ask to pay for legal services by credit card.

Some respondents flagged concerns regarding the use of payments with credit card, stating that it is difficult to obtain compensation through a claim under section 75 of the Consumer Credit Act. Others interpreted our reasoning around the use of credit cards in the consultation as suggesting that we compare the protection offered under section 75 of to those currently available to consumers under the Accounts Rules 2011. One respondent stated that we would be passing the risk on to the client.

There were a number of respondents who questioned if our intention was to require solicitors to have the facilities to accept payments for legal services by credit card.

Some respondents raised the following objections in principle to the use of credit cards:

- The Legal Services Consumer Panel has stated that the circumstances under which a claim would be successful are restricted to misrepresentation and/or a breach of contract.
- Consumers who do not have access to a credit card are generally more vulnerable. They would not have access to the same protections as those who can pay for legal services with a credit card. The proportion of society that does not have a credit card is unfairly disadvantaged by this.
- By encouraging the use of credit card to pay for legal services, we would be encouraging a culture of debt in society.
- If one of the intentions behind the draft rules is to lower costs and make legal services more available to consumers, the incremental costs of managing fees payable by the law firm on credit card transactions is prohibitive. The cost would likely be passed on to the consumer with the risk of increasing costs.

Some respondents raised a number of practical objections to the use of credit cards:

- One firm told us that if they received a payment from a debtor by credit card, they would not pass the money to the client until they were sure the payment was cleared and the funds could not be revoked. This could take up to six months.

- Consumers could recall a payment made to a firm for fees/disbursements if they were not happy with the advice given or the outcome in their case, leaving the law firm open to risk.
- Some credit card providers do not allow solicitors to receive payment for disbursements by credit card, only for their own fees.
- Legal fees can often run higher than the average person's credit limit, and the interest rates charged are prohibitive.
- It is not currently a popular choice among consumers to pay for legal services via credit cards. Many consumers (and firms) prefer payment via direct transfer (online banking).
- The cost of providing credit card payment facilities can be prohibitive to firms.

Question 4

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

Context

We asked this question to find out whether respondents agreed that only client money (as redefined) should be kept in a client account, or whether there should be flexibility for firms to agree different arrangements with their clients. For example, if a client wants to make payment for fees in advance or for those monies to be reserved from a previous settlement, whether these could be paid into, or continue to be held, in a client account.

We stated in the consultation that our preliminary view is that we should retain our current approach where only client money (as redefined) can be paid and held in a client account. This would be subject to some very limited exceptions around the treatment of mixed monies.[9]

Responses

About a quarter of respondents stated that they did not agree with this question as they did not agree with the proposed definition of client money. Those who disagreed with the question stated that fees and disbursements should continue to be paid into a client account as is done now. Some of those who disagreed stated that, under the current rules, it is easy to identify credits in business account that are held legitimately. If the definition changes, it would be more difficult to spot money that is incorrectly held in the firm's business or business account.

The majority of respondents agreed that only client money should be kept in a client account. Reasons for this include:

Accounting records would become too messy and complicated if firms were able to bank anything other than client money in a client account.

- Allowing only client money to be kept in a client account improves efficiency, reduces administration and avoids erroneous default.

[9] Question 5 asked respondents about our proposals regarding mixed monies.

- If money not classed as 'client money' was allowed to be held in a client account, there would be an increased risk of the separation between client and firm money becoming blurred.

Question 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 the new draft rule 4.2 (see annex 1.1)?

Context

Mixed payments are monies that are partially client money and partially money belonging to the firm. Under the current rules, mixed monies must be paid into client account and the portion of money belonging to the firm must be transferred into the business account within strict and set timelines.

We proposed to replace the current rule with a broader one, requiring mixed payments to be allocated promptly to the correct account, irrespective of where they are first paid. This intended to underpin a focus on where the money ends up and not into which account it is originally paid.

The current rule (rule 18.3) on mixed payments prescribes a strict 14 day timeframe for transferring any office money from the client account. In draft rule 4.2, rather than provide a prescriptive time limit as to when funds need to be transferred by, we have instead opted for the rule to state that funds must be transferred "promptly". We have chosen not to have prescriptive timeframes and instead give firms flexibility in operating their accounts.

Responses

Nearly all respondents requested that we provide guidance on the term "promptly". Firms expressed concerns that, without guidance, there is a risk of firms developing different practices and that the client money portion of any mixed funds paid into the firm’s business account could be forgotten.

A small majority of firms supported this proposal. They agreed that by removing the prescriptive timeframes, firms would be given greater flexibility around how they manage their accounts.

Other reasons respondents agreed include:

- Creating greater efficiency with fewer transfers being required between client account and business account.
- Preventing “technical” breaches of the rules, as sometimes mixed monies were mistakenly paid into the business account by bank transfer by clients. Under the proposed rules this would no longer constitute a breach.

A significant minority of respondents stated that the proposed rule was an unnecessary removal of client protection, and that money should continue to be paid into client account first.

Other reasons respondents disagreed include:

- If the rules were to allow mixed payments to be deposited into an business account without a firm deadline for when they must be transferred to the client account, there would be an inherent risk that a firm could manipulate their cash position using client funds.
- While changing the rule would allow firms greater flexibility, it would not reduce the administrative burden. This is because funds would still need to be allocated to the correct account within a reasonable timeframe.

Question 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)?

Context

We have proposed that the specific Accounts Rules regarding payments from the LAA should be removed. Our rationale is that firms carrying out solely LAA work in effect only receive money for payment on account of the firm's costs or for disbursements (for example, counsel and expert fees). In our consultation position on the definition of client money, these types of money would fall outside of the definition.

We explained that we would expect firms to continue to keep accurate records and make sure that any monies received and not utilised by the firm would be transferred to the client account or returned to the LAA. In addition, firms would be:

- bound by our Principles and Codes of Conduct
- bound by the terms of their contract with the LAA
- subject to the LAA's own rules and monitoring regime.

During the course of the consultation period, we had informal discussions with the LAA regarding our proposal. The LAA's initial view was that "advanced" and "regular" payments (which we would call payments on account and standard monthly payments) were not a problem as they are already payable into business account under the current contractual arrangements.

The LAA's view said that the proposed changes discard only the rule that advanced payments for disbursements (that is, payments to be made for professional services delivered by others) must be put into client account if the party providing the professional services is not paid within a specified time. The LAA said that relaxing the rules as proposed would not put LAA monies at an increased level of risk.

The LAA stated that risk arises either because some solicitors behave dishonestly or are insufficiently scrupulous as to the level of their claims. The LAA advised that all

their interactions regarding contributions and refunds of contributions to case costs are managed through their debt recovery contractor and the client directly. If at the end of the case a defendant is paid more than the final defence costs, or in the event of an acquittal (in which case they get a refund of all contributions paid), this would be refunded directly to the defendant. This means that it does not matter to the LAA which account monies are paid into.

There were not any circumstances that the LAA could think of where it would make payments to the solicitor/firm which were intended for the client.

Responses

A third of respondents chose not to answer this question on the basis that they do not deal with legal aid payments. Of those who did respond, a small majority stated that the rules could be safely dispensed with, as money from the LAA is usually paid after it is billed and therefore is never client money.

Reasons why respondents agreed included:

- There is no reason to have separate rules for handling LAA payments. These payments should be covered by the same rules as any other payments to firms.
- It is pleasing to have consistency irrespective of the source of funds.
- Removing the need to report to the LAA following third party payments before firms are able to take their costs is welcome.
- The treatment of funds should be based on their purpose, not from whom they are received.

Many respondents who disagreed stated that they did not support the removal of these rules because they did not support the change in definition of client money. Others voiced concerns around the high overdraft firms who work with the LAA tend to have. They stated that the reduction in legal aid payments in recent years mean that many firms struggle to survive as it is today. Removing the rules could lead to firms mismanaging their accounts in order to survive.

Other reasons why respondents disagreed included:

- Firms that have a high proportion of legal aid work tend to be ones which run higher overdrafts while they await payment of work done. Cashiers are under intense pressure from solicitors/partners to transfer every penny to business account. Having a rule is the only weapon to make sure the firm's accounts are kept in order.
- Relaxing the definition of client money and allowing the LAA money to be held in business account might result in money on account of costs being spent before the work has been carried out.

Question 7

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

Context

We have proposed to allow firms to use a TPMA as an alternative to client account. This means an account where a third party (a payment service provider) holds money on behalf of two or more transacting parties. In this case a third party would hold funds for a law firm and their client. Money held in a TPMA would not be subject to our Accounts Rules and TPMA providers would be regulated by the FCA.

Responses

The majority of respondents stated that they had no objections to the use of TPMA. Many commented that the use of a TPMA would not be a viable option for their firm. Others expressed views that while TPMAs may not be for them, it could be useful for smaller firms that do not handle large amounts of client money. A minority stated that they would wait and see what products the market develops before determining if a TPMA would be an option for them.

BARCO has expressed strong support for our proposal to allow TPMAs as an alternative to client account. BARCO stated that allowing the use of a TPMA will help us achieve our regulatory objectives of promoting competition in the provision of legal services. They have stated that the use of TPMA makes sure there is greater consumer protection and choice.

Other reasons why respondents agreed include:

- TPMAs could be an attractive alternative for those solicitors whose client money transactions are minimal.
- Firms who would not otherwise need a client account may find the option of having a TPMA attractive.
- The fact that a TPMA needs to be held with an FCA-regulated institution addresses concerns previously held, as FCA regulation appears to be proportionate and appropriate.

Of those who expressed objections to the introduction of TPMAs, many had concerns around the firm's liability in respect of the money and around what levels of oversight and control the firm would ultimately have over the funds in the TPMA.

Other reasons for objecting to the introduction of TPMAs include:

- The FCA will regulate TPMA providers. Some questioned why we were keen to move the handling of client money in certain circumstances outside of our regulation.
- Concerns that the FCA does not have a sufficient regulatory regime for overseeing TPMA provider activity.
- It is unclear if TPMAs would be covered by the Compensation Fund, and if firms that use a TPMA instead of a traditional client account would be exempt from paying contributions to the Compensation Fund.
- While not objecting in principle to introducing TPMAs, several respondents stated that they did not foresee the larger firms opting to use TPMA instead of a client account (as they would want to retain control over client funds).
- A few respondents have questioned what the benefit to consumers would be.

Question 8

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

The Law Society stated that it supports introducing TPMAs. It also stated that client protection arrangements for those using TPMAs are likely to be much more complex than those using traditional client accounts. This is because TPMA providers are regulated by the FCA and fall within the jurisdiction of the Financial Ombudsman Service, whereas comparable complaints about a solicitors' operation of a client account under the existing arrangements are the responsibility of LeO. It argued that the use of TPMAs may lead to increased consumer confusion over redress schemes and uneven client protections.

Many respondents who in principle supported the introduction of TPMAs raised questions regarding the uncertainty surrounding TPMAs, as there is not currently a wide market of providers.

Impacts or risks identified by respondents include:

- Further analysis needs to be undertaken on the effectiveness of TPMAs and of the FCA's regulation before the suitability of TPMAs can be determined.
- What are the risks relating to money laundering regulations? Particularly in relation to the potential number of shareholders in a TPMA company?
- What are the data controls and storage of data locations of the TPMA? How are confidentiality provisions aligned to those of regulated firms?
- Unclear what would happen in the event of the TPMA provider going insolvent.
- TPMAs could have implications for the Compensation Fund if we were to decide that these firms did not need to contribute.
- It is not clear whether PII providers would offer improved terms for those using TPMAs.
- Does the lawyer have all the responsibility and cost of opening the account?
- TPMAs could slow transactions down.
- TPMAs would incur additional costs to firms and more administration would be needed internally to release and record transactions
- Lack of control by the firm and issues around fraud detection and security surrounding funds held by other parties.

Question 9

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

Context

We asked this question as TPMAs were initially developed with a focus on receiving costs, disbursements and settlement monies. This is due to the speed and costs of service, which have made TPMAs less suitable for transactional payments.

BARCO has stated that it considers it appropriate for TPMAs to be used for transactional monies. It stated that it has been successfully assisting with commercial conveyancing for some time.

Responses

Reasons why respondents consider it appropriate to use TPMA for all monies include:

- Firms should have the discretion to make their own decisions on which solution best serves their business needs. It should not be for us to determine where the use of a TPMA is appropriate. This should be for each firm to determine.
- Provided that the TPMA has appropriate controls in place in relation to the protection of client monies, and the protection afforded to the consumer is not lessened, we do not need to explore this further.
- The consumer protection provided in the proposed rules will continue to apply. Use of TPMAs in relation to transactional work would further help to encourage more innovation, competition and choice.

Several respondents did not consider it appropriate for TPMAs to be used in transactional work as it is time sensitive and TPMAs do not allow for the same level of control over the transactional monies as a firm's own client account does. Other reasons why respondents disagree with using TPMAs for all monies include:

- Time is critical when it comes to completion of conveyancing matters. Using a TPMA for these transactions would increase the administration of releasing funds and has the potential for delay.
- Conveyancing completions have a life-changing impact on the client. The associated financial transactions relating to conveyancing matters would therefore be better served through a traditional client account, under the complete control of the firm and long established safeguarding processes.

Question 10

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

Context

The requirement in the Accounts Rules 2011 on firms to ensure that they have a written policy on the payment of interest has been removed and is instead reflected in provisions in the draft Code of Conduct for solicitors (standard 8.8). We asked

respondents whether there is a need to retain the requirement to have a published interest policy.

Responses

A majority of respondents stated that the requirement to have a published interest policy should be retained. A number stated that firms should still be required to state what their interest policy is in order for clients to be fully informed. The requirement for firms to pay a "fair sum of interest" should be abolished as it is out of date.

Many respondents seem to have misinterpreted this question as us asking whether firms should have to have a published interest policy, not if the requirement to have one should be retained in the Accounts Rules or be moved to the Code of Conduct.

A few respondents stated that proposed rule 7.2[10] potentially provides an easy interpretation for firms to avoid their obligation to pay a sum in lieu of interest to clients. For example, by exempting such payments in standard agreements offered to clients.

Reasons why respondents agreed that the requirement can be removed include:

- There should not be a requirement for a published interest policy. It should be for the firm to decide whether to publish it or not.
- If the interest policy is to be covered in the Code of Conduct, then that is sufficient in ensuring fair and reasonable interest is paid.
- The administrative burden on firms to handle payments in lieu of interest is disproportionate to the benefit to the client.
- Firms could instead set out in the client care letter whether the firm has a policy if making payments in lieu of interest on client funds held.
- There is no need for a published interest policy in engagements concerning sophisticated users of legal services.
- It is unnecessary to have a published interest policy as solicitors should hold monies for as little time as possible. Solicitors are not there to act as a financial institution and interest polices could imply that is what they are trying to do.

Reasons why respondents stated that the requirement should be retained include:

- A published interest policy is helpful in managing client expectations and making sure that all clients are dealt with equally.
- It is in clients' best interest to have a published interest policy, as it makes clear to them what they can expect from the firm at the outset of a matter.
- It is in the interest of consumers for law firms to communicate their policy on interest. Some consumers may hold large amounts of money in client account for long periods of time.
- Rule 8.8 in the draft Code of Conduct for solicitors contains an obligation to ensure publicity surrounding circumstances in which interest is payable by or to a client. There is no equivalent obligation in the draft Code of Conduct for firms, nor in the Accounts Rules. In practice, any interest policy would be

[10] Rule 7.2 provides: You may by a written agreement come to a different arrangement with your client or the third party for whom the money is held as to the payment of interest but you must provide sufficient information to enable them to give informed consent.

under the control of firms and not the individual solicitors. As such, it would be necessary for firms to have a clear policy of interest before the individual could fulfil their personal obligation in accordance with draft rule 8.8.

- There should be a requirement for firms to have an interest policy and to agree it with clients. If that requirement is elsewhere in the code, then there should be no need to replicate it in the Accounts Rules.

Question 11

Do you have any comments on the draft Accounts Rules, either as a whole or in relation to specific Accounts Rules (see annexes 1.1, 1.2 and 1.3)?

Many respondents stated in answer to this question that the proposed rules are sensible and more user friendly, and agreed that we have achieved simplification of the rules. However, many also said that they disagreed with the redefinition of client money, and do not believe that the change will be positive for firms or consumers.

Many respondents provided useful feedback and comments on a wide range of issues. Below are a few of the most commonly recurring themes:

- On the whole, the draft Accounts Rules seem simplified and sensible. They seem to be geared towards small practices and sole traders, particularly with the focus around whether there is a need for a client account, which, for the vast majority of firms, would still be required.
- It is not stated in the consultation what we consider the risks to client money to be, so the draft Accounts Rules lack context.
- The rules as drafted leave much room for interpretation, which could give rise to inconsistencies in application and put clients at risk.
- There would be a need for detailed transitional arrangements, so that firms have time to identify what monies currently held in client account need to be transferred to the business account under the new rules. There have also been requests for us to issue detailed guidance in this area, as there could be old residual balances that the firm is unable to determine if it is client money or not.
- Without seeing the guidance, it is hard to make an informed comment on the workability of the rules.
- The new rules should focus on removing technical breaches but it is not clear that they achieve the objective of keeping client money safe.
- Many respondents find rule 4[11] confusing and do not understand how it interacts with the other rules. One comment states: "We are also struggling to

[11] Rule 4: 4.1 You keep client money separate from money belonging to your firm. 4.2 You ensure that you allocate promptly any funds from mixed payments you receive to the correct client or business account. 4.3 Where you are holding client money and some or all of that money will be used to pay your costs:- (a) you must first give a bill of costs, or other written notification, to your client or the paying party before you transfer any client money to make the

understand the interplay of rules 2.1 (Client Money), and rule 4 (Client money must be kept separate). Rule 2.1 defines client money and rule 4 provides that client money must be kept separate from money belonging to the firm. Rule 4.3 deals with the scenario where a firm is "holding client money and [some or all] of that money will be used to pay costs". Would not such a scenario amount to a breach of rule 4.1, on the basis that 'client money' does not include payments received from clients in relation to 'fees'?
- Draft rule 9.1 and 10.1 introduce a reconciliation requirement for joint accounts and clients' own accounts respectively. These are not required in the current accounts rules.

Question 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.

Context

We are planning to issue a toolkit to go alongside the rules. The toolkit will contain a range of resources (guidance, case studies and questions and answers). At annex 1.5 to the consultation we provided an indicative list of areas that we will issue guidance on.

Responses

A number of respondents stated that it would have been useful to see the guidance in order to better understand how it is intended to work alongside the rules.

A few respondents stated that there is a risk we are perceived as trying to "regulate by the back door". The reasoning is that the Accounts Rules are not self-contained and sufficient to address the risks associated with handling client money.

Other respondents cautioned against issuing too much guidance, as this would not achieve our objective of simplification and would rather complicate the situation for firms trying to achieve compliance with the rules.

A large majority have requested that we issue guidance on how firms should deal with residual balances.

Other comments included:

- The list at annex 1.5 appears to be the Accounts Rules 2011 that have been excluded from the proposed rules
- Guidance on how firms might work to tackle cyber crime would be useful.
- Case studies on difficult scenarios and transaction areas would be useful.

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payment; (b) any such payment must be for the specific sum identified in the bill of costs or other written notification, and covered by the amount held for the particular client or trust.

- We should clarify if the guidance will give examples of compliance with the proposed rules, or if it will also give examples of scenarios that could result in non-compliance.
- An academic who responded to the consultation stated that a comprehensive suite of guidance and case studies would allow students and newly qualified solicitors to have confidence in their application of the rules. It would also help to teach the subject.
- The material we published in 2015 at the time of the revision to the scope of the reporting accountant's work was very useful in providing context as to what we wished their regulated entities to be focused on. Any guidance and examples that would set out how we would be likely to expect certain situations and transactions to be treated would be welcome.
- Case studies should include examples of trust accounts and what constitutes banking facilities. We should also cover situations where the funds cannot be returned promptly (eg, house sale where couple are splitting but have not agreed on where the sale proceeds should go).

Question 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?

Context

Our consumer impact analysis contained four potential scenarios and addressed the possible impacts by looking at each scenario and risks to clients. We stated in the analysis that the examples were extreme and in our view likely to be very rare. In most cases the new Principles and Codes of Conduct, together with the additional protection provided through the Accounts Rules will provide effective mitigation in relation to risks to client money.

Responses

A number of respondents did not agree with our impact assessment. Common reasons for disagreeing were that respondents did not believe the scenarios would be rare occurrences if the proposed rules enter into force. Respondents have also stated that the impact assessment is only focused on private consumers, and there is no assessment of the impact on commercial clients or on firms themselves.

Comments include:

- It appears as if there is an over-reliance on the possible protections offered to consumers from using credit cards to pay for legal fees, to which many have raised objections.
- The change in the definition of client money could result in fewer firms being required to contribute to the Compensation Fund, but the impact analysis suggests that consumers who have paid fees in advance could also claim on the Fund in the event of loss. There is a risk that the pool of available funds could be reduced, but the pool of possible claimants stays the same.

- For a consumer or supplier of third party disbursements, the proposals offer little comfort and do not differentiate a solicitor's practice from any other service.
- In the first example in the case study, one firm stated that they would not accept payment for a medical report by credit card because of chargeback rules.
- The impact assessment is weighted towards considering the positive impact for providers of legal services and seems to consider the consumer protection aspects somewhat superficially. We should seek input from consumers of legal services.
- Our impact assessment is inadequate. There should be a wider assessment on equality and diversity implications, in particular for small firms and, most importantly, for clients. It is hard to understand how we think our approach offers a better balance between regulatory burden and consumer protection when work on predicting the number of firms which would no longer need to operate a client account has not been undertaken.
- The redress would involve the costs being shared among all firms of solicitors so prudent and honest firms would incur greater costs. While there will always be firms or sole practitioners who do not keep money in client account when they should, the proposed rule on money on account being office money will only increase the claims to the Compensation Fund and professional indemnity policies. These costs would be borne by the profession as a whole.
- If credit card companies receive more claims for reimbursement for money paid to law firms, they may wish to increase the charges they levy on solicitors
- Options for redress would be slower, much less client friendly and more complicated. This will not help maintain public/consumer confidence in solicitors or the profession.

Question 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?

A third of respondents chose not to answer this question at all. Another third answered that they did not have any information to provide. Many who did answer offered their opinion on the consultation, but not any information or data as such.

The Law Society stated that we should undertake research, if we did not already have the data, to forecast any savings or expense to the profession. This should include additional costs through updating computer software. It should look at how these costs would impact groups with protected characteristics and whether some of the changes would result in increased administrative burden. We should also undertake research to develop an understanding of how the changes are likely to affect clients, particularly vulnerable clients.

Others who answered this question offered comments spanning a wide range of themes:

- Regulation should address the core difference between the need to protect individual consumers versus businesses or companies where a greater

degree of knowledge and business acumen is generally present. The rules might, therefore, have reference to the nature of the client.

- We should provide more details to support the assertion in the impact assessment that simpler and easier to understand rules would increase compliance and reduce costs.
- Firms that would no longer be required to obtain an accountants' report under the proposed rules (as a result in the change in definition of client money) may see a reduction in costs. But, it is unclear how there would be any significant reduction in costs for other firms if they continued to maintain strong systems and controls over client money.
- There would be a considerable impact on software vendors, which would take time for such vendors to change and implement their systems. This would be alongside the risk of bugs in the early stages, causing further confusion and potentially non-compliance. The scale and cost of the changes should not be under-estimated. There is an argument that if the same level software development resource was used to help minimise cyber crime or some other aspect of compliance, then that would represent a far more cost-effective use of resources and provide equal or better protection for consumers.