Public- Item 7(b)

SRA Board
1 June 2016

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Looking to the Future: Phase 3 of the Accounts Rules Review

Purpose

1 To present the Board with proposals for Phase 3 of the Accounts Rules review.

Recommendations

2 The Board is asked:

a) to note the direction of travel set out in the consultation paper and specific proposals to:

- amend the Accounts Rules so they are focused on the key principles for keeping money safe, resulting in a much shorter set of Rules supported by guidance and case studies (paragraph 10). We have adopted the same drafting approach as applied to the draft Codes of Conduct being considered separately by the Board

- focus more clearly on what is client money and what is the firm's money - including a change in the definition of client money (paragraphs 11 to 17) and removal of references to *office money* and *office account*

- enable firms to make use of Third Party Managed Accounts (TPMA) as a mechanism for holding client money should they choose to (paragraph 10)

b) to approve the following documents for consultation:

- Consultation paper including consultation questions and draft SRA Accounts Rules [2017] (Annex 1)

- Initial Impact Assessment (Annex 2)

c) to agree that we launch the consultation alongside the Handbook consultation in the public session of the Board. The consultation will run for a period of 16 weeks and we will continue with the programme of engagement already underway.

If you have any questions about this paper, please contact: Crispin Passmore Executive Director, Policy crispin.passmore@sra.org.uk or 0121 329 6687

SRA Board
1 June 2016

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Looking to the Future: Phase 3 of the Accounts Rules Review

Background

3 Our regulatory reform programme includes a review of the SRA Accounts Rules 2011 ('the Accounts Rules'), which govern the handling of client money by those we regulate. The core purpose of the Accounts Rules is to ensure that money belonging to clients is kept safe.

4 Our review of the Accounts Rules began in 2014 and has already delivered changes to the requirement in the Accounts Rules to obtain an independent accountant's report. The requirement to obtain a regular accountant's report is an important check on risks to client money but is also a significant cost to firms. Phases 1 and 2 have therefore made changes to ensure our requirements are proportionate and targeted at risks to consumers. We have reduced the number of firms required to obtain an accountant's report and now require only qualified reports (i.e. those that highlight risks to client money) to be submitted to us[1]. The changes also mean that reporting accountants must use their judgement to assess risks to client money rather than taking a check list approach to completing their report (and determining whether it should be qualified or not).

5 The third and final phase has looked more widely at our existing Accounts Rules and makes proposals for broader change. We asked stakeholders in our earlier consultations whether or not they would support more fundamental change to shorten and simplify the Accounts Rules. In response we received broad support for a wide ranging review.

6 The Accounts Rules have not been properly reviewed for nearly 20 years and were left largely unchanged during the last review of the Handbook in 2011. They are prescriptive and restrictive, and focused on ensuring all firms handle money in the same way. The current rules as drafted would not pass any assessment against the better regulation principles.[2] Their length and complexity makes it difficult for new entrants to understand what is required while many existing firms find themselves in technical breach of the Rules in circumstances where there are no real risks to client money.

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[1] The first phase was implemented through rule changes that came into effect on 31 October 2014 that:

- removed the requirement for firms to obtain an accountant's report for the small number of firms which receive 100% of their client money from the Legal Aid Agency
- changed the requirement to submit an accountant's report to us so that only qualified reports need to be provided

The second phase involved further changes to our accountant's report requirements and was implemented on 1 November 2015. Those changes:

- changed the format of the reporting process allowing accountants to exercise professional judgement and apply an outcomes-based approach to assessing compliance with the Rules
- removed the requirement to obtain an accountant's report from firms that have an average client account balance of no more than £10,000 and a maximum balance of no more than £250,000 in an accounting period

[2] The better regulation principles require that regulators are proportionate, accountable, consistent, transparent and targeted

7 We recognise that changes will have an impact upon a broad range of SRA regulated firms that hold client money as well as consumers, reporting accountants, insurers, mortgage lenders, and others in the financial sector. We have therefore been engaging with these stakeholders and will continue to do so throughout the consultation. We have also worked with internal stakeholders across the SRA to ensure any impacts are understood.

8 The Policy Committee has considered two papers on Phase 3 of the Accounts Rules review. The first in March 2016 set out our policy proposals and asked for feedback on the direction of travel. The second in May 2016 presented the proposed draft rules and a draft consultation paper. The documents being presented to the Board reflect the feedback from Policy Committee – received both in the meeting itself and in reviews of multiple drafts of the documents. In short, the documents have been subject to thorough scrutiny by the Policy Committee in advance of coming to the Board for approval.

Rationale

9 Effective mitigation of the risk that client money will be misused has always been, and remains, a priority for the SRA. Many firms find themselves in technical breach of the Accounts Rules in circumstances where there are no real risks to client money. For example, as highlighted in our earlier consultation[3] on reporting accountant's requirements, of the approximately 9,000 firms that hold client money, in the period June 2012 to December 2013, over 50% received a qualified accountant's report but only 179 were referred to consideration for further regulatory action[4]. This suggests that our Accounts Rules are too complicated and are not focussed on the key risks to client money.

10 The core purpose of the Accounts Rules is to ensure that money belonging to clients is kept safe and separate from money belonging to the firm. The current rules go beyond what is needed to achieve the objective of keeping client money safe. Several rules are there to try to help firms rather than helping us manage regulatory risks – for example telling firms the exact number of days they are permitted to hold client money outside client account in certain circumstances. But in effect this creates unnecessary restrictions for firms and removes responsibility[5].

11 Our objective is to rationalise and simplify the rules. We aim to remove any unnecessary restrictions, prescription and detail while, at the same time, maintaining appropriate consumer protections. We have followed the same drafting principles as for our wider review of our SRA Handbook[6].

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[3] Consultation published June 2014 http://www.sra.org.uk/sra/consultations/reporting-accountant.page

[4] http://www.sra.org.uk/Solicitors_Regulation_Authority/sra/how-we-work/board/public_meetings/archive/SEP14_7_-_Reporting_Accountant_Requirements.pdf

[5] Rule 18.3 requires that in the case of mixed payments (made up of a combination of client money, office money and other monies), client money must be transferred out of the client account within 14 days of receipt

[6] We are consulting at the same time on Phase 1 of our Handbook Review including the Principles, Code of Conduct for Solicitors and Code of Conduct for Firms

12 This ensures the Accounts Rules are more flexible for firms – but also that they are properly focused on the real risks to client money. This shifts responsibility for firms from compliance with detailed rules (many of which do not really address real risks to client money), to compliance with the core principle of the rules – keeping client money safe.

Summary of the changes

13 In this consultation we propose to:

- **Simplify the Accounts Rules**: by focusing on key principles and requirements for keeping client money safe, including:
    - keeping client money separate from firm money
    - ensuring client money is returned promptly at the end of a matter
    - using client money only for its intended purpose
    - proportionate requirements for firms to obtain an annual accountant's report.

  This will put the focus on what is important and allow firms greater flexibility to manage their business. The Accounts Rules will also be simpler and easier to understand - increasing compliance and reducing compliance costs. The Accounts Rules will be supported by an online toolkit which will comprise of guidance and case studies to aid compliance.

- **Change the definition of client money:** to allow money paid for all fees and disbursements for which the solicitor is liable (for example counsel fees) to be treated as the firm's money. Money held for payments for which the client is liable, such as stamp duty land tax, will continue to be treated as client money and therefore required to be held in client account. The impact of the proposed change in definition is expected to remove the need to have a client account for some firms and therefore reduce the associated compliance costs. The changes may also reduce the number of firms required to obtain an accountant's report through the subsequent reduction in the client account balance.

- **Provide an alternative to the holding of client money:** through the introduction of clear and consistent safeguards around the use of third party managed accounts (TPMA) as a mechanism for managing payments and transactions.

Key issues - definition of client money

14 In modernising the Accounts Rules we are also looking at the definition of client money. The current detailed definitions of both client money and office money have evolved and been added to over many years. We are therefore proposing a simpler definition based on liability for payment.

15 In our view, the proposed changes to narrow the definition of client money provide a better balance between consumer protection and regulatory burden. A discussion of the key issues is set out in paragraphs 15 to 35 of the consultation paper.

16 Following feedback from Policy Committee we have amended the consultation to make clear that this argument is finely balanced and seek views on consultation.

17 Initial feedback from Compliance Officers for Finance and Administration (COFAs) in large and medium firms as well as from Multi Disciplinary Practices (MDPs) suggests the narrower definition is more in step with the approach taken by other professional regulators and in other jurisdictions. However, as we have identified in the consumer protection analysis at Annex 1.4 to the consultation – there are some circumstances where the changes could potentially result in a reduction in consumer protection.

18 We have therefore been upfront in the draft consultation paper of the potential impacts on consumer protections – particularly in respect to the effort and time required to pursue an appropriate remedy should things go wrong. We have also included questions in both the draft consultation paper and impact assessment as to whether our assessment of the risks to consumers and associated mitigations is appropriate.

19 Policy Committee members were content that the revised drafting addresses concerns raised previously as to the rationale for the changes.

20 We are expecting to receive a wide range of views on this issue in consultation and will be engaging with stakeholders to fully understand all potential impacts. The Board will also note that we are not proposing changes to the scope of the SRA Compensation Fund at this time. The related issues will be considered as part of our review of the Professional Indemnity Insurance and Compensation Fund which we will return to the Board with later this year.

Stakeholder engagement

21 We have engaged with a range of external stakeholders as we develop our proposals including:

- Reporting accountants and their representative bodies – including presentations at ICAEW roadshow events in Bristol, York, London and Manchester where we have had the opportunity to hear feedback on the changes to the reporting accountant requirements and start to test our thinking for the new Rules. It will be important to continue this engagement as we review implementation of the Phase 2 changes later in the year and start to adapt our guidance for firms and reporting accountants to fit with the proposed changes to the Rules
- We have reviewed ICAEW's client money regulations[7] and have a meeting with ICAEW scheduled for 17 May where we will be discussing our proposals in more detail and looking at how we can work with ICAEW to ensure engagement with its members throughout the consultation period. An update can be provided at the Board meeting.

[7] http://www.icaew.com/en/members/regulations-standards-and-guidance/practice-management/clients-money-regulations

- SRA regulated firms that may or may not currently hold client money – both through our general engagement with firms and in relation to permitting the use of BARCO in specific circumstances. At a recent discussion with COFAs (from large to medium London firms), we received broad support for our plans to consult on a narrower definition of client money and to simplify the Rules - particularly from MDPs and global firms - where our approach to fees paid in advance and professional disbursements are out of step with the approach taken in other jurisdictions. The firms were optimistic that shorter and simpler rules would create much needed flexibility. In some areas they suggested we go further, for example in allowing firms discretion over whether money that is no longer defined as client money is allowed to go into the client account. We will ask a specific question on this issue in the consultation. We will be returning to speak to the same group in the summer once the consultation has launched and they have had opportunity to review the draft Rules.
- City of London Law Society (CLLS) - we have been engaging with CLLS closely in relation to the draft Codes of Conduct. We have shared a short summary briefing on the Accounts Rules changes with CLLS and with our virtual reference groups ahead of consultation. An update on feedback received will be provided at the Board meeting.
- MDPs – particularly large accountancy firms facing issues with the compatibility between our Rules and ICAEW Rules. There are also issues for global firms with the compatibility of our rules with international audit standards (which prevent the holding of client money altogether) - initial feedback suggests that the proposed change in definition would address these issues. Again we will continue these discussions throughout the consultation period.
- TPMA providers - we have had several discussions with BARCO who are the only TPMA provider at the moment and with other providers who are looking to develop a product. We understand that some of the banks are also looking at doing so. We are unable to include information from these discussions in our public documents due to commercial confidentiality but it is clear from discussions that a clear SRA policy position to allow TPMA is likely to lead to more innovation in this part of the market and the development of improved products for keeping client money safe. Such developments are currently being held up by us having to review applications on a case by case basis.
- Insurers through our regular liaison group - in particular we are keen for insurers to respond to the consultation regarding the potential impact of TPMA on PII premiums. Insurers have indicated to us that the use of TPMA would likely result in reduced premiums. If this message were made publicly it is likely to increase interest in the use of these products

22 We have also been engaging with internal stakeholders throughout the policy development process. We have a cross organisational project team which includes representatives from a range of SRA functions including authorisation, supervision, legal and enforcement, adjudication and consumer protection. This

helps us to ensure all impacts are considered. We have also held a number of workshops to test the draft rules.

Recommendations

23 The Board is asked:

a. To note the direction of travel set out in the consultation paper and specific proposals to:

- amend the Accounts Rules so they are focused on the key principles for keeping money safe, resulting in a much shorter set of Rules supported by guidance and case studies. We have adopted the same drafting approach as applied to the draft Codes of Conduct being considered separately by the Board.

- focus more clearly on what is client money and what is the firm's money - including a change in the definition of client money (set out in paragraphs 15 to 35) and removal of references to *office money* and *office account.*

- Enable firms to make use of Third Party Managed Accounts (TPMA) as a mechanism for holding client money should they choose to

b. To approve the following documents for consultation:

- Consultation paper including consultation questions and draft SRA Accounts Rules [2017]

- Initial Impact Assessment

c. To agree that we launch the consultation alongside the Handbook consultation in the public session of the Board. The consultation will run for a period of 16 weeks and we will continue with the programme of engagement already underway.

Consultation

24 During the consultation period we will continue to engage with key stakeholders noted above that have helped inform proposals and also more widely as we launch this consultation and our consultation on the Code of Conduct for solicitors and firms. Our engagement will run through the course of the consultation period through a variety of ways for example, road shows, webinars, consumer events and social media activity.

Next steps

25 We will return to the Policy Committee with our initial analysis of the consultation responses in November 2016 and update the Board in December 2016. Post-

consultation proposals are likely to be put before the Board in the first quarter of 2017. Our second consultation on the SRA Handbook will set out details in relation to the implementation of rules and associated operational impacts, including our authorisation, practice framework and disciplinary rules.

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Supporting information

Links to the Strategic Plan and/or Business Plan

26 The proposals are linked to Strategic Objective One: We will reform our regulation to enable growth and innovation in the market and to strike the right balance between reducing regulatory burdens and ensuring consumer protection.

27 The proposed changes to the SRA Accounts Rules to deliver Phase 3 of a programme of reform are integral to our wider objectives to ensure that regulation is proportionate and targeted, with the aim of removing unnecessary burdens and taking steps to ensure that the rules are simplified and modernised, while providing appropriate levels of consumer protection.

How the issues support the regulatory objectives and best regulatory practice

28 The proposals will make regulation more proportionate and targeted by focusing the protections provided by the Accounts Rules on those areas where there are real risks to client money and removing unnecessary burdens. When assessing our approach to the review of the Accounts Rules against the regulatory objectives it is important that our arrangements protect and promote the interests of consumers. However, we do not consider that one objective should be given greater weight. The primary objective of the Accounts Rules has to be to ensure that client money and assets are properly protected and there remains an adequate level of financial protection for consumers. This does not mean that all consumers need the same level of protection, rather that the level of protection should be appropriate to the needs of a range of different consumers. Further, the objective of the Accounts Rules must be balanced against the need to offer flexibility to firms for how they meet their duties to safeguard money and assets belonging to clients.

Public/Consumer impact

29 There are some risks in the new approach which need exploring, particularly in terms of how the proposals for a change in definition may impact on the level of consumer protection. We consider that on balance the risk of consumer detriment is more than mitigated by the potential redress mechanisms available, albeit that these take considerable time and determination for clients to pursue.

30 We have explored the issues further in our initial Impact Assessment at Annex 2 and in the consumer protection analysis that accompanies the consultation paper.

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1 June 2016

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Solicitors Regulation Authority

What engagement approach has been used to inform the work and what further communication and engagement is needed

31 Please refer to paragraph 18 in the main paper.

What equality and diversity considerations relate to this issue

32 Please see our initial Impact Assessment at Annex 2.

How the work will be evaluated

33 Please see our initial Impact Assessment at Annex 2.

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Date 13 May 2015

Annexes

Annex 1 - Draft consultation paper including draft SRA Accounts Rules [2017] and other supporting annexes

Annex 2 - Draft initial Impact Assessment

SRA Board
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DRAFT CONSULTATION PAPER

Looking to the Future: SRA Accounts Rules Review

Introduction

1 The SRA is the regulator of solicitors and law firms in England and Wales, protecting consumers and supporting the rule of law and the administration of justice. The SRA does this by overseeing all education and training requirements necessary to practise as a solicitor, licensing individuals and firms to practise, setting the standards of the profession and regulating and enforcing compliance against these standards. Further information is available at www.sra.org.uk

2 Our regulatory reform programme includes a review of the SRA Accounts Rules 2011 ('the Accounts Rules'), which govern the handling of client money by those we regulate. The core purpose of the Accounts Rules is to ensure that money belonging to clients is kept safe. Our objective is to rationalise and simplify the rules. We aim to remove any unnecessary restrictions, prescription and detail while, at the same time, maintaining appropriate consumer protections. We have followed the same drafting principles as for our wider review of our Handbook[8].

Background

3 This is the third (and final) phase of our review of the Accounts Rules. Phase one came into effect in October 2014. This made minor changes to the format of the annual accountant's report that firms were required to obtain, and introduced an exemption for certain firms from the need to obtain that report[9]. We also removed the requirement for firms to submit to us reports where these found no failure to comply with the Accounts Rules. Phase two was implemented in November 2015, and encouraged reporting accountants to apply an outcomes-based approach to assessing compliance, with a greater focus on risks to client money. We also extended the exemption from the obligation to obtain an accountant's report to firms that have 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[10].

4 The third phase has looked more widely at the existing Accounts Rules and makes proposals for broader change. The current Accounts Rules have not changed significantly for many years. They are prescriptive and restrictive, and focused on ensuring all firms handle money in the same way. In our view, the rules currently in force would not pass any assessment against the better regulation principles.[11]

[8] We are consulting at the same time on Phase 1 of our Handbook Review including the Principles, Code of Conduct for Solicitors and Code of Conduct for Firms

[9] Where 100% of work is funded by legal aid

[10] For the rationale of the exemptions based on client account balance please refer to Phase 2 of our Accounts Rules review - see consultation document published November 2014 http://www.sra.org.uk/sra/consultations/reporting-accountant.page

[11] The better regulation principles require that regulators are proportionate, accountable, consistent, transparent and targeted

5 Effective mitigation of the risk that client money will be misused has always been, and remains, a priority for the SRA. This is done through a combination of outcomes in the Code of Conduct; detailed provisions in the Accounts Rules for the separation and handling of client money, and obligations placed on a firm's managers and Compliance Office for finance and administration (COFA)[12].

6 However, the length and complexity of the current Accounts Rules makes it difficult for new entrants to the market to understand what is required of them as well as consumers to understand what to expect when a firm handles their money. Further, many firms find themselves in technical breach of the Accounts Rules in circumstances where there are no real risks to client money. For example, as highlighted in our earlier consultation[13] on reporting accountant's requirements, of the approximately 9000 firms that hold client money, in the period June 2012 to December 2013, over 50% received a qualified accountant's report but only 179 were referred to consideration for further regulatory action[14]. This suggests that our Accounts Rules are too complicated and are not focussed on the key risks to client money.

Proposals for change

7 We propose to:

- **Simplify the Accounts Rules**: by focusing on key principles and requirements for keeping client money safe, including:
  - keeping client money separate from firm money
  - ensuring client money is returned promptly at the end of a matter
  - using client money only for its intended purpose
  - proportionate requirements for firms to obtain an annual accountant's report.

  This will put the focus on what is important and allow firms greater flexibility to manage their business. The Accounts Rules will also be simpler and easier to understand - increasing compliance and reducing compliance costs. A draft of the proposed Accounts Rules is provided at **Annex 1.1**. The Accounts Rules will be supported by an online toolkit which will comprise of guidance and case studies to aid compliance.

- **Change the definition of client money:** to allow money paid for all fees and disbursements for which the solicitor is liable (for example counsel fees) to be treated as the firm's money. Money held for payments for which the client is liable, such as stamp duty land tax, will continue to be treated as client money and therefore required to be held in client account. The impact of the proposed change in definition is expected to remove the need to have a client account for some firms and therefore reduce the associated compliance costs. The changes may also reduce the number of firms required to obtain

[12] Consumers also have access to the SRA Compensation Fund in the event that money is misappropriated or otherwise not accounted for (by a defaulting practitioner or their employee or manager). So while the Accounts Rules are intended to keep client money safe, there is an additional safeguard through the compensation fund.
[13] Consultation published June 2014 http://www.sra.org.uk/sra/consultations/reporting-accountant.page
[14] http://www.sra.org.uk/Solicitors_Regulation_Authority/sra/how-we-work/board/public_meetings/archive/SEP14_7_-_Reporting_Accountant_Requirements.pdf

an accountant's report through the subsequent reduction in the client account balance.

- **Provide an alternative to the holding of client money:** through the introduction of clear and consistent safeguards around the use of third party managed accounts (TPMA) as a mechanism for managing payments and transactions.

Links with our Handbook Review

8 The Accounts Rules are intended to work together with our new Principles and Codes of Conduct, which we are consulting on separately alongside this consultation.

9 Under the combined proposals we will have:

- Standards that apply to all solicitors
- Standards that apply to regulated firms
- Accounts Rules that apply to firms we regulate, their managers and employees and who hold client money (as now more narrowly defined) or who have dealing with other money belonging to clients, for example through operating a client's own account as signatory or by their use of TPMA).

10 The proposed standards in our draft Code of Conduct for solicitors will apply to all individual solicitors, RELs and RFLs we regulate, wherever they work, and will require the following in relation to client money and assets:

4.1 You properly account to ***clients*** for any ***financial benefit*** you receive as a result of their instructions.

4.2 You safeguard money and ***assets*** entrusted to you by ***clients*** and others.

4.3 Unless you work in an ***authorised body***, you do not personally hold ***client money***.

11 The proposed Code of Conduct for Firms replicates standards 4.1 and 4.2.

12 The requirement to safeguard money and assets entrusted by clients is deliberately drafted to be wider than the proposed definition of client money. So while the Accounts Rules will be focused on client money held by firms we regulate, all solicitors and firms will be bound by these wider duties in the Codes of Conduct along with our Principles. **Annex 1.5** includes an example case study which highlights the obligation set out in the Codes of Conduct to safeguard monies and assets.

13 There are a number of other standards in the draft Codes of Conduct that mitigate the risks involved in dealing with client money[15]. For example, solicitors

[15] These include the duty to *ensure clients understand whether and how the services you provide are regulated and the protections available to them (outcome 8.9)*

will be required to give their clients information in a way they can understand, explain the options available to them and provide the best possible information about pricing[16].

14 As the handling of client money remains a high risk area, we believe that it remains necessary to have separate Accounts Rules to address those risks. The Accounts Rules set out our expectations as to how client money should be kept safe, and the systems and controls, and accounting processes we expect to see. We therefore propose to retain a standalone set of Accounts Rules applicable to all SRA authorised firms and their employees and managers, compliance with which is also the responsibility of the firm's COFA (Compliance Officer for Finance and Administration).

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

A new definition of client money and client liability

Our proposal

15 While the proposed simplification of the Accounts Rules (set out in paragraph 7) will remove much of the prescription within the Accounts Rules and offer firms greater freedom in how they manage their accounts, it does not address the core issue of what money should be protected by the Accounts Rules. We have therefore reviewed the definition of client money and are proposing a change to the definition which we consider strikes a better balance between consumer protection and regulatory burden.

Draft Rule 2.1:

"***Client money***" is money held or received by you:

(a) relating to legal services delivered by you to a *client*, excluding payments for your fees and payments to third parties for which you are liable;
(b) on behalf of a third party in relation to legal services delivered by you (such as money held as agent, stakeholder or held to the sender's order);
(c) as a trustee or as the holder of a specified office or appointment, such as a donee of a power of attorney, *Court of Protection deputy* or trustee of an occupational pension scheme.

16 Under the proposed definition, if a firm is holding money on behalf of a client (for example estate monies held in connection with a probate) or where the client has provided funds to cover their liabilities to a third party (for example in relation to residential property transaction to pay Stamp Duty Land Tax or completion monies) - that money will still be considered client money and must therefore be paid into client account. If the payment relates to legal services being provided by the firm to the client (for example fees paid by the client in advance) or services rendered on behalf of the client for which the firm is liable (for example costs

[16] Draft SRA Code of Conduct for Solicitors, RELs and RFLs [2017], 8.6 and 8.7

relating to the client's matter which might include medical expert fees, counsel fees, or indirect costs such a courier fees) - it does not have to go into client account.

17 The proposed change in definition allows us to dispense with the current detailed descriptions in the Accounts Rules about different types of disbursements as well as the definition of office money and office account. How a firm manages its money should be for the firm to consider having regard to its other obligations in our Accounts Rules, any legal obligations and its assessment of its own financial stability. Where necessary we have instead referred to the firm's own money or to business accounts rather than office money and office account.

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)?

Rationale

18 Under the current definition of client money, we treat fees paid in advance (which is client money) differently to fixed fees (which are not). This is an odd distinction which has evolved over time. Unlike the case in many other markets, solicitors routinely request payment in advance or on account of their fees or for other payments they may be required to make to third parties on the clients' behalf prior to completion of the work or before the client has been billed. Our Accounts Rules facilitate and normalise the payment of money in advance in this way and require that it is held in client account. But from a consumer perspective, the payment for services in this way is at odds with the way they purchase many other services. And for firms, it does not provide much flexibility for different approaches and business models. For instance, for Multi-Disciplinary Practices (MDPs) operating under ICAEW rules as well as our own – the current definition causes issues in relation to the treatment of fees as ICAEW rules on client money do not make the same distinction between agreed fees and payment of account of costs. Under ICEAW rules, fees paid in advance for professional work agreed to be performed and clearly identifiable as such shall not be regarded as client' money[17].

19 We want both firms and consumers of legal services to have a range of options available to them. We already know that consumers are increasingly opting for fixed fee services. Research shows that use of fixed fee arrangements has increased from 38% to 46%[18] of legal transactions. When both the cost itself and uncertainty about cost are two of the most significant barriers to consumers accessing legal advice, fixed fees are a good thing. They allow consumers to

[17] Under ICAEW Rules - Clients' Money means money of any currency (whether in the form of cash, cheque, draft or electronic transfer) which a Firm holds or receives for or from a client, including money held by a Firm as stakeholder, and which is not immediately due and payable on demand to the Firm for its own account. Clients' Money must be held in the currency in which it was received unless the client instructs otherwise in writing – see http://www.icaew.com/en/members/regulations-standards-and-guidance/practice-management/clients-money-regulations

[18] http://www.legalservicesconsumerpanel.org.uk/publications/research_and_reports/documents/Choosing_legal_services_000.pdf

know what the work will cost up front and to have certainty over those costs. This makes it easier for consumers to compare costs and shop around.

20 Under the current Accounts Rules, payments for fixed or "agreed" fees can be paid into the office account even if the work has not yet been done whereas payment for services that have not yet been billed must be treated as client money (and paid into client account).

21 We are therefore proposing to simplify our approach so that all payments for fees are treated the same under our Accounts Rules.

22 We do not think it is the right approach to change our position on fixed fees so as to require these payments to be paid into client account because they are fees for a service.

23 The level of protection currently applied to payment of fees in advance under the current Accounts Rules is significant. It ensures that this money is kept separate from the firm's money and in the event of the firm's insolvency is capable of being returned back to the client if the work has not been done (by the appointed insolvency practitioner or through use of our intervention powers). However it also adds costs through the requirement to maintain a separate client account just for these payments and comply with our Accounts Rules.

24 It is arguable that our Accounts Rules - in making separate provision for payment of fees in this way - may encourage or normalise the business practice of requiring consumers to pay in advance for services and before the costs have been calculated. The impact of this may be to increase the amount of money in client account in the first place and potential risks to consumers if that money is lost.

25 This issue is finely balanced but overall we consider that wider developments in consumer protection mean that we can safely reduce the current high levels of consumer protection provided in relation to fees paid in advance. For instance, consumers may choose to pay by credit card and take advantage of the protections available in consumer legislation if the supplier does not provide the agreed services in part or in full (so long as the services were bought for between £100 and £30,000)[19]. A recent Financial Conduct Authority (FCA) market study found that 60% of consumers have at least one credit card. We are particularly interested in views on how the market may react to the use of credit cards for payments, for example whether firms currently facilitate payment by credit card or the extent to this may change. We are also interested in whether there are any impacts in terms of access to credit cards among certain socio-economic groups.

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

[19] Section 75 of the Consumer Credit Act. A consumer guide to what to expect has been produced by the UK cards Association
http://www.theukcardsassociation.org.uk/wm_documents/creditcard_yourights_a_consumer_guide%281%29.pdf

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

26 Where firms continue to require payment in advance or consumers cannot pay by credit card, consumers also have access to redress through the Legal Ombudsman in certain circumstances if something goes wrong[20]. Under the current arrangements, consumers (if eligible[21]) would also have the ability to claim on our Compensation Fund (which is not currently restricted to the definition of client money). For example, if a firm becomes insolvent and a firm was intervened into we would return money collected from the firm's client account (via our Statutory Trust powers). For any money not held in client account (as would be the case for fees or payments to third parties where the work has not yet been done) - consumers would be apply to apply for a payment from our Compensation Fund. The subsequent risk however is that we would see an increase in claims on the fund as a result. This is an issue we will need to consider separately as part of our review of professional indemnity insurance and compensation arrangements later this year.

Payments to third parties

27 Solicitors quite often handle payments relating to the case on a client's behalf - for example payments to other lawyers, professional experts and counsel . They may also handle payments for courier charges or other associated fees such as Land Registry search fees. These are currently referred to in our Accounts Rules as disbursements and the rules distinguish between professional disbursements (which are client money) and other types of disbursements (which are not client money).

28 As with our approach to fees, we are proposing to simplify this position in the Accounts Rules. Payments for professional services for which the firm is liable should in our view be treated as any other liability of the firm. We have included, for the avoidance of doubt, an express reference in the draft rule (Rule 2.1) to client money excluding payments in advance for fees and payments to third parties for which the firm is liable.

29 We recognise this is a change for firms in terms of the way they manage their businesses and accounting systems. We therefore welcome views from firms as to the specific impacts of this proposal.

Risks in our approach

30 We recognise that our proposals for the definition of client money represent a potential reduction in consumer protection if clients continue to pay for costs in advance and do not pay for these by credit card. In the event that work is not completed, clients would have access to redress through the Legal Ombudsman (LeO) but this takes time and effort to pursue. There are also risks to the client if payments to third parties are not paid by the firm – for instance it might mean that client matter is not progressed as it should. However, for the reasons set out we

[20] Redress mechanism via LeO for financial loss, distress and inconvenience (up to £50k)
[21] See Rule 3.7 of the SRA Compensation Fund Rules 2011

consider the proposed approach offers a better balance between consumer protection and regulatory burden.

31 We think the revised definition of client money is clearer and focuses protections where the potential harm to consumers of the money being lost are significant, such as property transactions and probate. This is supported by data from the Compensation Fund which shows we have paid out over £3m for payments associated with property transactions in the past two years[22]. We consider that this money must therefore be paid into a client account and be kept there until properly withdrawn.

32 We accept that the proposal removes some protections for those other than the clients (for example Counsel and other experts). We consider that these risks in relation to payments for which the solicitor is liable are adequately addressed through clear duties to act in the client's best interests. We would therefore expect:

- sufficient accounting records of transactions kept by the firm including client transactions through the firm's business accounts
- firms to comply with the standards required in respect of giving adequate cost information, delivering bills, and returning any surplus costs or money promptly

33 This focuses less on where the money is held and more upon the responsibility to provide a good service to clients and to act in their best interests. Should the worst happen and money be lost and/or the client adversely affected, they have access to a range of consumer protections which have improved since the definitions of client money and office money were first put in place a number of years ago.

34 We have presented some examples of the risks posed to consumers and potential impacts at **Annex 1.4** along with the initial Impact Assessment. We welcome views on our assessment of these risks. In particular, we would welcome views on whether we have identified the main detriments and whether that on balance the risk is more than mitigated by the potential redress mechanisms available, albeit we accept that they may take considerable time and determination for clients to pursue.

Flexibility and Mixed Payments

35 Two further related points arise from this proposal:

- A question of flexibility and whether or not only client money can be paid into client account (as in the current Accounts Rules) or whether there should be flexibility for clients to agree different arrangements;
- How we treat mixed payments – where there is a combination of client money and money that will belong to the firm.

[22] Data from the Compensation Fund shows we paid out over £3m for payments consumers were liable for to HMRC and the Land Registry.

Flexibility - the use of client account for other payments

36 Under the current Accounts Rules, only client money is permitted to be held in client account. While mixed payments may be paid into client account in the first instance, any portion that is deemed to be office money must be transferred out of the client account within 14 days of receipt[23].

37 We are seeking views on whether or not only client money (as redefined) can continue to be paid into the client account or whether there should be flexibility for clients to agree different arrangements. For example, if a client wants to make payments for fees in advance or for those monies to be reserved from a previous settlement, whether these could be paid into client account?

38 Our preliminary view is that we should retain the current approach. This is because it is clearer to apply and could also be problematic in terms of an intervention into a firm as we would have difficulties with identifying what money is genuinely client money over which we have statutory powers and what money belongs to the firm. There is also the potential for funds belonging to the firm to be used improperly to conceal shortfalls in the client account or where client money should have been deposited in the client account. We therefore consider that we should continue to apply the principle in the Accounts Rules that only client money can be held in client account subject to some very limited exceptions around the treatment of mixed payments.

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?

Mixed payments

39 The concept of mixed payments[24] relates to monies that are partially client money and partially money belonging to the firm, for example, where a solicitor receives a cheque for damages due to a client, their fees and other disbursements. The current Accounts Rules relating to mixed payments, while detailed, are designed to address the risk of client money being wrongly held in office account for lengthy periods of time. This risk does not fall away under a change to the definition. Mixed payments will continue to exist under the proposed changes to the definition; in fact the likelihood of a firm receiving mixed payments is likely to increase as a result of the change. We are seeking views on whether mixed payments should continue to be paid into a client account first, as now, or whether we can be more flexible in the new Rules. For example, we could focus our rules on where the money ends up rather than where it is paid into in the first instance.

40 Our current view is that a degree of flexibility is desirable. We therefore propose to replace the existing prescriptive requirements that mixed payments must be paid into client account with a broader requirement requiring mixed payments to be allocated promptly to the correct account whether that is client account or a business account.

[23] SRA Accounts Rules, Rule 18.3
[24] SRA Accounts Rules, Rule 18

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)?

Payments from the Legal Aid Agency (LAA)

41 The Accounts Rules (currently in force) set out two special dispensations which apply to legal aid payments:

(a) An advance payment, which may include client money, may be placed in an office account (provided the LAA instructs in writing that this may be done)

(b) A payment for costs may be paid into an office account, regardless of whether it consists wholly of office money, or is mixed with client money in the form of:

(i) advance payments for fees or disbursements; or

(ii) money for unpaid professional disbursements;

provided all money for payment of disbursements is transferred to a client account (or the disbursements paid) within 14 days of receipt.[25]

42 In addition, the firm on completion of a matter must pay any outstanding professional disbursements or transfer a sum for those amounts to the firm's client account.

43 With regards to money received from the LAA, our understanding is that firms would only ever receive money for payment on account of the firm's costs or for disbursements (for example, counsel's and expert fees). As set out above, these types of money will fall outside of the proposed new definition of client money and will therefore not be held in a client account. We would there propose to remove the specific Accounts Rules which deal with the treatment of LAA money.

44 We expect that the continued obligation to reconcile accounts and keep accurate records will ensure that any monies received and not utilised by the firm will be dealt with appropriately and returned to the LAA promptly where necessary . In addition, firms will be bound by the terms of their contract with the LAA and subject to the LAA's own Accounts Rules and monitoring regime. Of note, if the SRA was to intervene into a firm and it was established that work had not been done for which payment had been received then the SRA's statutory trust provisions would apply (meaning that monies will be returned to the LAA by the SRA). However, if the money was paid into an overdrawn office account there will be no claim on the Statutory Trust as the money will clearly have gone[26] and the loss would not be covered by the Compensation Fund[27].

[25] http://www.sra.org.uk/solicitors/handbook/accounts/part4/rule19/content.page
[26] A claim on the Statutory Trust can only succeed if the money was there at the point of intervention – that is more likely to be the case with money in client account than in office account as intervened firms are invariably overdrawn.
[27] Rule 8.1 (h) of the SRA Compensation Fund Rules 2011

45 We are discussing this position with the LAA to determine whether we can safely dispense with the specific Accounts Rules relating to payments from the LAA (currently Rule 19).

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)?

An alternative arrangement to holding client funds - TPMA

46 We have previously consulted[28] on our proposal to allow firms to use alternatives to holding client money, through the use of a Third Party Managed Accounts ("TPMA"). This would be an option for firms rather than a requirement. By this we mean accounts 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 or solicitor and their client. As our Accounts Rules apply to client money which is held or received by the solicitor or firm themselves, money held in a TPMA is not subject to our existing requirements.

47 In our previous consultation we asked whether our Accounts Rules should require that we approve each arrangement to use a TPMA on an individual basis or whether we should set general standards for those arrangements to meet. We suggested a list of desirable features that we thought TPMAs should satisfy[29].

48 There was broad support from respondents regarding the proposals. However, a large number of respondents felt this matter merited a separate, single-issue consultation. We therefore decided[30] to proceed with the development of Accounts Rules to permit TPMA but to incorporate this work into our wider review of the Rules and to use the briefing paper "Alternatives to Handling Client Money"[31] (compiled by the legal services regulators of England and Wales) to inform our work on TPMAs. In the meantime as our current Accounts Rules do not expressly prevent the use of TPMA, we decided to consider requests from firms on a case by case basis in order to satisfy ourselves that the arrangements were suitable[32].

Our approach to TPMAs

49 Our objective for allowing TPMA is to provide sufficient flexibility for firms to meet their obligation to safeguard client money and assets and alternative options for clients. This flexibility must be balanced with appropriate levels of consumer protection. The use of TPMA is relatively untested. We therefore need to consider

[28] TPMA consultation - http://www.sra.org.uk/sra/consultations/regulatory-reform-programme.page
[29] Independence of the third party from the transacting parties, transparency of status and ownership of the third party, a third party regulated by the Payment Services Regulator, clear mechanisms for dealing with disputes, clear provisions for termination of the arrangement
[30] http://www.legalservicesboard.org.uk/projects/statutory_decision_making/pdf/2015/20150917_Annex_2_SRA_Board_Public_Item_8_Improving_Regulation.pdf
[31] http://www.legalservicesboard.org.uk/what_we_do/pdf/20150720_Proposals_For_Alternatives_To_The_Handling_Of_Client_Money.pdf
[32] http://www.sra.org.uk/documents/SRA/board-meetings/2015/board-2015-09-09-improving-regulation.pdf

the consumer impacts carefully. For instance, it may be that TPMA is only appropriate for use with certain types of clients or categories of work and not others. Or it may be the benefits of increased choice and access for those consumers that are currently excluded from the legal services market is sufficient justification to go ahead and allow TPMA in all circumstances. Our starting point for TPMA has been to look at the extent to which these services are regulated already.

50 Not all escrow service providers are regulated as financial service providers. Therefore we are suggesting restricting TPMAs to those operated by payment services providers which are FCA regulated under the Payments Services Regulations 2009. As TPMAs are already subject to regulation by the FCA, we see no reason to place additional requirements relating to the providers of those services. We therefore propose to allow firms to use a TPMA if:

a) the TPMA is either an authorised payment institution and a result has mandatory safeguarding arrangements, or is a small payment institution which has adopted voluntary safeguarding arrangements; and,

b) they can demonstrate that the firm has suitable arrangements for the implementation, use and monitoring of TPMAs. For example that use of TPMAs is suitable for the types of transactions, appropriate information is provided to clients and appropriate internal controls are in place.

51 Our draft Accounts Rules (**Annex 1.1**) set out the arrangements we propose to introduce to enable firms to use a TPMA in order to mitigate any risks to the client as the end user:

- the provision of information to the client, especially prior to entering into a TPMA arrangement, to ensure a clear understanding of the terms of the contract and the right to terminate the agreement;
- the requirement to cooperate with the SRA and to maintain proper financial records; and,
- arrangements for interest payments.

FCA Regulation of TPMAs

Payment service providers are regulated by the FCA as a payment institution under the Payment Services Regulations 2009 (PSR).

However, the level of regulation differs depending on whether the TPMA is an authorised payment institution or a small payment institution. Small payment institutions (which have a monthly payment value of less than Euro3m) are not subject to mandatory safeguarding arrangements but can choose to adopt safeguarding requirements.

There are 2 ways in which payment institutions can choose from to safeguard. They are:

a. The segregation method which requires funds to be held separate from all other funds. Either in an authorised credit institution authorised by the FCA or invested in secure liquid assets held by an authorised custodian. The safeguarding account must be named in a way that shows it is a safeguarding account and not used to hold any other funds or assets. Funds safeguarded in this way are protected from the claims of other creditors;

b. The insurance or guarantee method by which the funds are covered by an insurance policy with or guarantee from an authorised insurer payable in an insolvency event.

A payment institution must maintain systems and controls that minimise the risk of loss or diminution of relevant funds or assets through fraud, misuse, negligence or poor administration and be managed by individuals who possess appropriate knowledge and experience and are of good repute.

Funds held in a segregated account with an authorised credit institution will be subject to the FCS guarantee. All payment institutions are subject to FCA Rules on handling complaints and consumers and micro-enterprises have access to the Financial Ombudsman Service. However to ensure that a firm's clients have access to FOS the agreement between the firm, the client and the TPMA provider may need to contain appropriate terms. Payment institutions are subject to conduct of business requirements relating to the information to be provided to the customer in relation to transactions and rights and obligations. However these will not protect the firm's client unless the contract contains appropriate terms.

Market viability of TPMAs

52 TPMAs initially developed with a focus on costs, disbursements and settlement monies. This is due to the speed and costs of the service, which made it less suitable for transactional payments.

53 If we proceed with the proposed change to the definition of client money set out in this consultation, it is likely the drivers for using a TPMA will change. If firms

are able to hold fees paid in advance and certain disbursements outside of client account, it is perhaps unlikely that they will choose the additional costs of operating a TPMA for these funds.

54 The success of the TPMA market will of course depend on TPMA providers offering a service in a way that is commercially attractive to firms (and their clients) as an alternative to holding a client account, and which offers sufficient speed and security of transactions. It may also be affected by other incentives such as the reduction of premiums for professional indemnity insurance. This is something we are considering as part of our impact assessment.

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

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

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 TPMA be restricted to certain areas of law? If so, why?

Key changes in the new Accounts Rules?

55 Key changes that we have proposed in the Accounts Rules include:

- removing the current reference to the Accounts Rules applying only to practice from an office in England and Wales as well as references to Exempt European Practices (EEPs). This is because of the proposal to allow solicitors to practice in firms that are not regulated by the SRA. We are consulting separately on the impact of these changes on the current EEP regime and whether there will be a continued need for an approval regime to allow RELs to do so in circumstances where they are providing foreign legal advice and unreserved services.
- removing the reference in the current Accounts Rules (Rule 1) to the SRA Principles thereby removing the potential for confusion about the scope of the COFA's responsibility extending to compliance with conduct requirements.
- key principles for when withdrawals from client account can be made, based around the purpose for which the client money is being held and a much simpler requirement that other withdrawals can be made in circumstances that we prescribe. This will allow us to place the detail of the thresholds and safeguards into more flexible and expanded guidance
- The duties to remedy have been retained as we consider that they are important
- The existing requirement on firms to ensure that they have a written policy on the payment of interest will be removed and reflected in provisions in the draft Code of Conduct of Solicitors (standard 8.8).
- Rule 8 sets out client accounting systems requirements. We have retained the requirement to obtain bank statements and do 5 weekly reconciliations as

we consider that both are important mechanisms to ensure firms, their reporting accountants and our supervisory and enforcement functions can check compliance.

56 Rule 12 sets out the requirements on firms to obtain and deliver accountant's reports. Although recently reviewed and amended as part of Phase 2 of our review, we have taken the opportunity to reduce the length and detail of the applicable Accounts Rules. In particular, we are very interested to hear about the practical application of the current exemptions for small amounts of money held and whether the maximum limit of £250,000 is necessary. Finally, we have removed the existing Rule 47 dealing with production of documents and information as the provisions are already set out in the draft Codes of Conduct for Individuals and Firms.

57 Later this year we will have the opportunity to review the implementation of the Phase 2 changes and we will consider any issues that review raises alongside the responses to this consultation.

What do the Accounts Rules not contain?

58 We have removed detailed references in the Accounts Rules to those taking appointments such as Court of Protection Deputies and as Trustees of an Occupational Pension Scheme. We have simplified the Accounts Rules by confirming that monies held by these appointees are client money and the Accounts Rules therefore apply in full (including the requirements to pay interest), subject to any conflicting obligations to comply with the relevant statutory schemes. We have also removed references to circumstances where solicitors take insolvency appointments. Where a solicitor takes an insolvency appointment in a bankruptcy matter or company liquidation then they are required to pay all money received in the course of carrying out their functions into the Insolvency Services Account (ISA) kept by the Secretary of State. Voluntary liquidators may deposit funds into the ISA.

59 Finally we have replaced the specific waiver provision about accountants' reports with a more general and flexible approach to waivers as will be set out in our waivers policy.

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

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)?

Support package for firms

60 We appreciate that some firms prefer a more detailed approach and we intend to issue an online support package for firms. The toolkit will provide firms with a range of tools and resources (guidance on key topics, case studies and questions and answers) to help them understand the regulatory requirements and deliver services in a compliant way. Moving the current guidance notes from the

Accounts Rules to separate documents will allow us to regularly update them in line with other developments. **Annex 1.5** sets out an indicative list of areas that we will issue guidance on and example case studies. We welcome feedback on the areas we have identified and on other areas that guidance or case studies might be useful.

61 The toolkit will not form part of the SRA Handbook. How firms use the toolkit will depend every much on their size, the activities they engage in and the needs of their clients.

62 We will also be reviewing the materials produced as part of Phase 2 changes to the reporting accountant requirements (including the AR1 Form) – as these are based upon 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.

Impact of our proposals

63 An initial high level impact assessment has been developed and should be reviewed alongside this consultation. This sets out the SRAs early assessment of the likely impact of our proposals primarily on firms and consumers. We would welcome views from respondents, with a particular emphasis on any data or evidence that will assist us in finalising our impact assessment.

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?

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?

Next steps and implementation timetable

64 This formal consultation is open for sixteen weeks, closing on 21 September 2016.

65 In line with our published consultation policy, we will pro-actively target and facilitate discussion with key stakeholders, including firms likely to be affected by these proposals.

66 Our second consultation on the SRA Handbook will set out details in relation to the implementation of rules.

SRA Board
1 June 2016

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Annexes

Annex 1.1 - Draft SRA Accounts Rules [2017]
Annex 1.2 - Draft SRA Account Rules glossary
Annex 1.3 - Destination table
Annex 1.4 - Consumer Protection analysis
Annex 1.5 - Indicative list of guidance areas and example case studies

SRA Board
1 June 2016

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Consultation questions

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

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?

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

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?

Question 5: Do you agree with our proposal that mixed monies can be paid into client or business account as ling 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)?

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)?

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

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

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 TPMA be restricted to certain areas of law? If so, why?

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

Question 11: Do you have any comments on the draft Accounts Rules, either as a whole or in relation to specific 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, pleas provide further details.

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?

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?

SRA Board
1 June 2016

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How to respond to this consultation

Online

Use our online consultation questionnaire {insert link} to compose and submit your response. (You can save a partial response online and complete it later.)

Email

Please send your response to consultation@sra.org.uk. You can download and attach a Consultation questionnaire [insert link].

Please ensure that

- you add the title "SRA Accounts Rules 2017" in the subject field,
- you identify yourself and state on whose behalf you are responding (unless you are responding anonymously),
- you attach a completed About You form,
- you state clearly if you wish us to treat any part or aspect of your response as confidential.

If it is not possible to email your response, hard-copy responses may be sent instead to:

Solicitors Regulation Authority
Regulation and Education - SRA Accounts Rules 2017
The Cube
199 Wharfside Street,
Birmingham,
B1 1RN

Deadline

Please submit your response by 21 September 2016.

Confidentiality

A list of respondents and their responses may be published by the SRA after the closing date. Please express clearly if you do not wish your name and/or response to be published. Though we may not publish all individual responses, it is SRA policy to comply with all Freedom of Information requests.

SRA Board
1 June 2016

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Annex 1.1 - Draft Accounts Rules

Draft SRA Accounts Rules [2017]

Introduction

These rules set out our requirements for when firms authorised by us receive or deal with money belonging to clients, including trust money or money held on behalf of third parties. The rules apply to all firms we regulate, including all those who manage or work within such firms.

Firms will need to have systems and controls in place to ensure compliance with these rules and the nature of those systems must be appropriate to the nature and volumes of client transactions dealt with and the amount of client money held or received.

PART 1: GENERAL

Rule 1: Application section

1.1 These rules apply to ***firms***, their ***managers*** and ***employees*** and references to "you" in these rules should be read accordingly.

1.2 The ***firm's managers*** and ***COFA*** are jointly and severally responsible for compliance by the ***firm***, its ***managers*** and ***employees*** with the rules.

1.3 In relation to a ***MDP***, the rules apply only in respect of your ***regulated activities*** and do not apply to "***out of scope money***".

PART 2: CLIENT MONEY AND CLIENT ACCOUNT

Rule 2: Client money

2.1 "***Client money***" is money held or received by you:-

relating to legal services delivered by you to a ***client***, excluding payments for your fees and payments to third parties for which you are liable;

on behalf of a third party in relation to legal services delivered by you (such as money held as agent, stakeholder or held to the sender's order);

as a trustee or as the holder of a specified office or appointment, such as a donee of a power of attorney, ***Court of Protection deputy*** or trustee of an occupational pension scheme.

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

(a) in relation to money falling within 2.1(c), to do so would conflict with your obligations under rules or regulations relating to your specified office or appointment**;** or

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

2.3 You ensure that ***client money*** is available on demand unless you agree an alternative arrangement in writing with your ***client,*** or the third party for whom the money is held***.***

2.4 You ensure that ***client money*** is returned promptly to the ***client***, or the third party for whom the money is held, as soon as there is no longer any proper reason to retain those funds.

Rule 3: Client account

3.1 You only hold a ***client account*** at a branch (or the head office) of a ***bank*** or a ***building society*** located in England and Wales.

3.2 You ensure that the name of any ***client account*** includes:-

(a) the name of the ***firm***; and

(b) the word “client” to distinguish it from any other type of account operated by the ***firm***.

3.3 You must not use a client account to provide banking facilities to clients or third parties. Payments into, and transfers or withdrawals from a ***client account*** must be in respect of instructions relating to the delivery by you of legal services or as a result of your acting as a trustee or as the holder of a specified office or appointment.

Rule 4: Client money must be kept separate

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 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.

Rule 5: Withdrawals from client account

5.1 You only withdraw ***client money*** from a ***client account***:-

(a) for the purpose for which it is being held; or

(b) following receipt of instructions from the client, or the third party for whom the money is held; or

(c) on the ***SRA***'s prior written authorisation or in the circumstances prescribed by the ***SRA*** from time to time.

5.2 You appropriately authorise and supervise all withdrawals or payments made from ***client account***.

5.3 You can only withdraw ***client money*** from ***client account*** if sufficient funds are held on behalf of that specific ***client*** or trust to make the payment.

Rule 6: Duty to correct breaches upon discovery

6.1 You correct any breaches of the rules promptly upon discovery. Any money improperly withheld or withdrawn from a ***client account*** must be immediately paid into the account or replaced as appropriate.

Rule 7: Pay interest where appropriate

7.1 You account to ***clients*** or third parties for a fair sum of ***interest*** on any ***client money*** held by you on their behalf.

7.2 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.

Rule 8: Client accounting systems and controls

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

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

(b) record in client ledgers identified by the client name and an appropriate description of the matter to which they relate, all receipts and payments and bills of costs including transactions through your ***firm***'s business accounts;

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

8.2 You obtain, at least every five weeks, statements from ***banks***, ***building societies*** and other financial institutions for all client and business accounts held or operated by you.

8.3 You complete at least every five weeks, for all ***client accounts*** held or operated by you, a reconciliation of the bank statement balance to the cash book balance and to the client ledger total, which must be signed off by the ***COFA*** or a ***manager*** of the ***firm***.

8.4 You keep readily accessible a central record of all bills or other written notifications of ***costs*** given by you.

PART 3 – DEALINGS WITH OTHER MONEY BELONGING TO CLIENTS OR THIRD PARTIES

Rule 9: Operation of Joint accounts

9.1 If, when acting in a ***client's*** matter, you hold or receive money jointly with the ***client*** or a third party, part 2 of these rules do not apply save for:

(a) rule 8.2- statements from banks, building societies and other financial institutions;

(b) rule 8.3 – reconciliations;

(c) rule 8.4 - bills and notifications of costs.

Rule 10: Operation of a client's own account

10.1 If, in the course of practice, you operate a ***client's*** own account as signatory, part 2 of these rules do not apply save for:

(a) rule 8.2- statements from banks, building societies and other financial institutions;

(b) rule 8.3 – reconciliations;

(c) rule 8.4 - bills and notifications of costs.

Rule 11: Third Party Managed Accounts

11.1 You may enter into arrangements with your ***client*** to use a ***third party managed account*** for the purpose of receiving payments from or on behalf of, or making payments to or on behalf of, your ***client*** in respect of legal services delivered by you to your ***client***, only if:

(a) use of the account does not result in you receiving or holding your ***client's*** money;

(b) you satisfy yourself that the arrangements are appropriate for the legal services that you are delivering for your ***client***;

(c) you satisfy yourself that the arrangements ensure that your ***client's*** money is safe; and

(d) you take reasonable steps to ensure, before accepting instructions, that your ***client*** is informed of and understands:

(i) the terms of the contractual arrangements relating to the use of the ***third party managed account***, and in particular how any fees for use of the ***third party managed account*** will be paid and who will bear them; and

(ii) the ***client's*** right to terminate the agreement and dispute payment requests made by you.

11.2 You obtain regular statements from the provider of the ***third party managed account*** and ensure that these accurately reflect all transactions on the account.

Rule 12: Obtaining and delivery of accountants' reports

12.1 If you have, at any time during an ***accounting period***, held or received ***client money*** or operated a joint account or a ***client's*** own account as signatory, you must:-

(a) obtain an accountant's report for that ***accounting period*** within six months of the end of the period; and

(b) deliver it to the SRA within six months of the end of the ***accounting period*** if the accountant's report is qualified as result of a failure to comply with these rules, such that the safety of money belonging to ***clients*** or third parties is, or has been, or is likely to be placed, at risk.

12.2 You are not required to obtain an accountant's report if:-

(a) all of the ***client money*** held or received during an ***accounting period*** is money received from the Legal Aid Agency; or

(b) in the ***accounting period***, the statement or passbook balance of client money you have held or received does not exceed:

(i) an average of £10,000; and

(iii) a maximum of £250,000,

or the equivalent in foreign currency.

12.3 In Rule 12.2 above a "statement or passbook balance" is the total balance obtained at least once every five weeks, from a ***bank***, ***building society*** or other institution of all ***client accounts***, and joint accounts and clients' own accounts under rules 9 and 10 above, when carrying out reconciliations in accordance with Rule 8.3 above.

12.4 The ***SRA*** may require you to obtain or deliver an accountant's report on reasonable notice if the ***SRA*** has reason to believe that it is in the public interest to do so.

12.5 If you stop holding or receiving ***client money*** (or operating any joint account or ***client's*** own account as signatory), rule 12.2 does not apply and you must obtain and deliver a final accountant's report to the ***SRA,*** whether qualified or unqualified, within 6 months of the date you stopped holding or receiving the money.

12.6 You ensure that any report obtained under this rule is prepared and signed by an accountant who is a member of one of the ***chartered accountancy bodies*** and who is, or works for, a registered auditor.

12.7 The ***SRA*** may disqualify an accountant from preparing a report for the purposes of this rule if:

the accountant has been found guilty by their professional body of professional misconduct or its equivalent; or

the ***SRA*** is satisfied that the accountant has failed to exercise due care and skill in the preparation of a report under these rules.

12.8 The ***SRA*** may specify from time to time matters that you must ensure are incorporated into the terms on which an accountant is engaged.

12.9 You must provide to an accountant preparing a report under these rules:-

(a) details of all accounts kept or operated by you in connection with your practice at any ***bank***, ***building society*** or other financial institution at any time during the ***accounting period*** to which the report relates; and

(b) all other information and documentation that the accountant requires to enable completion of their report.

12.10 The accountant must complete and sign their report in the form prescribed from time to time by the ***SRA***.

Rule 13: Storage and retention of accounting records

13.1 You must store all ***accounting records*** securely, and retain these for at least six years.

Supplemental notes

E.g. Powers, commencement /transitionals

Authority: made by the Solicitors Regulation Authority Board under sections 32, 33A, 34, 37, 79 and 80 of the Solicitors Act 1974, section 9 of the Administration of Justice Act 1985, section 83(5)(h) of, and paragraph 20 of Schedule 11 to, the Legal Services Act 2007 with the approval of the Legal Services Board;

date: xxxx ;

replacing: the SRA Accounts Rules 2011.

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Annex 1.2 - Draft SRA Account Rules glossary

Glossary - in order of appearance in current Draft Rules	Definition
Firm	*means:* *(i) save as provided in paragraphs (ii) and (iii) below, an authorised body or a body or person which should be authorised by the SRA as a recognised body or whose practice should be authorised as a recognised sole practice (but which could not be authorised by another approved regulator); …….*
Manager	means: (i) the ***sole principal*** in a ***recognised sole practice*** (ii) a ***member*** of an ***LLP***; (iii) a ***director*** of a company; (iv) a ***partner*** in a ***partnership***; or (v) in relation to any other body, a member of its governing body.
Employee	*means an individual who is:* (i) engaged under a contract of service by a firm or its wholly owned service company; (ii) engaged under a contract for services, made between a firm or organisation and: (A) that individual;

	(B) an employment agency; or (C) a company which is not held out to the public as providing legal services and is wholly owned and directed by that individual; or (iii) a solicitor, REL or RFL engaged under a contract of service or a contract for services by an authorised non-SRA firm; (iv) a solicitor, REL or RFL engaged under a contract of service or a contract for services by a person, business or organisation, under which the firm, authorised non-SRA firm, person, business, or organisation has exclusive control over the individual's time for all or part of the individual's working week; or in relation to which the firm or organisation has designated the individual as a fee earner in accordance with arrangements between the firm or organisation and the Lord Chancellor (or any body established by the Lord Chancellor to provide or facilitate the provision of services) pursuant to the provisions of the Legal Aid, Sentencing and Punishment of Offenders Act 2012
COFA	means a compliance officer for finance and administration and in relation to a licensable body, is a reference to its ***HOFA.***
MDP	means a licensed body which is a multi-disciplinary practice providing a range of different services, only some of which are regulated by the SRA.
Regulated activities	means: (i) subject to sub-paragraph (ii) below: (A)any reserved legal activity; (B)any non-reserved legal activity except, in relation to an MDP, any such activity that is excluded on the terms of the licence;

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	(C)any other activity in respect of which a licensed body is regulated pursuant to Part 5 of the LSA; and …..
Out of scope money	means money held or received by an MDP in relation to activities that are not regulated activities.
Client money	has the meaning given in Rule 2.1 of the SRA Accounts Rules [2017]
Court of Protection deputy	for the purposes of the SRA Accounts Rules includes a deputy who was appointed by the Court of Protection as a receiver under the Mental Health Act 1983 before the commencement date of the Mental Capacity Act 2005
Client account	means an account of the firm for the purpose of holding **client money** in accordance with these rules
Client	Means the person for whom you act and, where the context permits, includes prospective and former clients
Bank	has the meaning given in section 87(1) of the Solicitors Act 1974.
Building society	means a building society within the meaning of the Building Societies Act 1986.
Mixed payments	Means a payment that includes both ***client money*** and non-client money

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Costs	means your fees and disbursements
SRA	means the Solicitors Regulation Authority, and reference to the SRA as an approved regulator or licensing authority means the SRA carrying out regulatory functions assigned to the Society as an approved regulator or licensing authority.
Interest	includes a sum in lieu of interest.
Third party managed account	means an account held at a bank or building society in the name of a third party which is an authorised payment institution, a small payment institution that has chosen to implement safeguarding arrangement in accordance with Regulation 19 (13) of the Payment Services Regulation 2009 or an EEA authorised payment institution (as each defined in Regulation 2 of the Payment Services Regulations 2009) regulated by the Financial Conduct Authority, in which monies are owned beneficially by the third party, and which is operated upon terms agreed between the third party, you and your client as an escrow payment service
Chartered accountancy bodies	means the Institute of Chartered Accountants in England and Wales; or the Institute of Chartered Accountants of Scotland; the Association of Chartered Certified Accountants and t he Institute of Chartered Accountants in Ireland; or the Association of Authorised Public Accountants
Accounting records	means all reconciliations, bank and building society statements (paper or electronic), original passbooks, signed letters of engagement with reporting accountants, the accountants' reports (whether qualified or not), any client's written instructions to hold client money other than in accordance with these rules, records and documents, including electronic records, relating to the third party managed accounts and any other records or documents necessary to show compliance with these rules

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Annex 1.3 - Destination table

Current provision	*Retained (and simplified)*	*Removed*	*Merged*	*Added (new)*	*Destination in proposed draft rules (note new Rule 11 on TMPA)*
Rule 1 - the overarching objective and underlying principles		X			n/a
Rule 2 - interpretation		X			n/a
Rule 3 - geographical scope		X	X		n/a
Rule 4 - persons governed by the rules			X parts of rules 4 and 6 merged		Rule 1
Rule 5 – persons exempt from the rules		X			n/a
Rule 6 – Principal's responsibility for compliance	X				Rule 1
Rule 7 - Duty to remedy breaches	X				Rule 6
Rule 8 – Liquidators, trustees in bankruptcy, Court of protection deputies and			X		One element in Rule 2.2(a)

trustees of occupational pension schemes					
Rule 9 – Joint accounts	X				Rule 9
Rule 10 – operation of a client's own account	X				Rule 10
Rule 11 - firm's rights not affected		X			n/a
Rule 12 – categories of money			X		Rule 2.1
Rule 13 - client accounts	X				Rule 3
Rule 14 – use of client account			X parts of rules 14 and 15 merged		Rule 2.2,2.3,2.4 Rule 3.3
Rule 15 – client money withheld from client account on client's instructions			X parts of rules 14 and 15 merged		Rule 2.2
Rule 16 - other client money withheld from client account	X				
Rule 17- receipt and transfer of costs			X parts of rules 17 and 18 merged		Rule 4.2, 4.3

rule 18 – receipt of mixed payments			X parts of rules 17 and 18 merged		Rule 4.2
rule 19 – treatment of payments to legal aid practitioners		x			n/a
rule 20 – withdrawals from client account			X parts of rules 20 and 21 merged		Rule 5
rule 21 – method of and authority for withdrawals from client account			X parts of rules 20 and 21 merged		Rule 5
rule 22 – when interest must be paid			X parts of rules 22,23,24 and 25 merged		
rule 23 – amount of interest			X parts of rules 22,23,24 and 25 merged		
rule 24 - interest on stakeholder money			X parts of rules 22,23,24 and 25 merged		
rule 25 - contracting out			X parts of rules 22,23,24 and 25 merged		
rule 26 – guidelines for accounting procedures and systems		X			n/a
Rule 27 – restrictions on transfers		X			n/a

between clients					
Rule 28 – executor , trustee or nominee companies		X			n/a
Rule 29 – accounting records for client accounts etc	X				Rule 8
Rule 30 – accounting records for clients' own accounts			X parts of rules 30 and 31 merged		Rule 13
Rule 31- production of documents, information and explanations			X parts of rules 30 and 31 merged		Rule 13
Rule 32 – Obtaining and delivery of accountant's reports	X				Rule 12.1. 12.2, 12.3,12.4
Rule 33- Accounting periods			X		New glossary definition Rule 12.5, 12.6
Rule 34- Qualification for making a report	x				Rule 12.7
Rule 35 – Reporting accountant's rights and duties – letter of engagement	x				Rule 12.9

Rule 36- Change of accountant		x			n/a
Rule 37- Provision of bank accounts etc			X Parts of rule 37 and 39 merged		Rule 12.10
Rule 38- Work to be undertaken			X Parts of rule 38 and 40 merged		Rule 12.1 (b) , 12.11
Rule 39 - Failure to provide documentation			X Parts of rule 37 and 39 merged		
Rule 40- Form of accountants' report			X Parts of rule 38 and 40 merged		Rule 12.11
Rule 41- Firms with two or more places of business		x			n/a
Rule 42 – Waivers		X			New waivers guidance applies
Rule 43 – Purpose of rules applying to RELS in Exempt European Practices (EELs)		X			n/a
Rule 44 – Application and Interpretation (EELs)		X			n/a

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Rule 45 – Client money (EELs)		X			n/a
Rule 46 – Accountant's reports (EELs)		X			n/a
Rule 47 – production of documents, information and explanations (EELs)		X			n/a
Rule 48 – Waivers (EELs)		X			n/a

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Annex 1.4 - Consumer Protection analysis

Our proposals will make the Accounts Rules shorter, simpler and therefore easier to understand and comply with. The changes will also allow more flexibility for firms, while introducing a much clearer focus on the protection of client money.

However, there are of course some risks in the new approach which need exploring, particularly in terms of how the proposals for a change in definition may impact on the level of consumer protection. The table below addresses the potential impacts by looking at different scenarios which pose a risk to clients.

It should be noted that these are extreme examples and in our view are likely be very rare. In most cases the Principles and Codes of Conduct, together with the additional protections provided through the Accounts Rules, will provide effective mitigation in relation to risks to client money.

We therefore consider that on balance the risk of consumer detriment is more than mitigated by the potential redress mechanisms available, albeit that these take considerable time and determination for clients to pursue.

We welcome view from respondents on our assessment of these risks and the potential impacts.

Scenario and risk	Impact	Redress/Regulatory Action
A firm asks a client for payment on account of money to be used to pay for a medical expert and pays the money straight into the office account (as would be allowed under the Accounts Rules with a change of definition). This will allow the firm to use that money (mixed with all other money belonging to the firm) to pay staff salaries. However the firm is at the limit of its overdraft and as a result the expert is not paid for several months.	• Delay in that client's matter which may lead to that person not receiving damages as soon as he might. • The expert refuses to take on legal work in the future with broader detriment to access to good quality evidence • Risk that client has to pay again	• Our Accounts Rules will require firms to have systems in place to ensure that this cannot happen through oversight • Report to us and potential investigation for breach of our Accounts Rules as the firm is not safeguarding money belonging to clients or acting in the best duty of the client (standards in the Codes of Conduct) • Redress mechanism via LeO for financial loss and distress and inconvenience (up to £50k) • If payment made by credit card and delay in service derives from delay in payment, section 75 of Consumer Credit Act may apply if amount is between £100 and £30,000
A firm does not offer	• The client is left out of	• Redress mechanism via LeO for

fixed fees for general litigation work and asks instead for payment on account of costs. A client pays over £2000. The firm then fails to do the work.	pocket and without the work being done – leading to delay and inconvenience • The experts and other third parties are not paid and will have to be paid again by the client if the work is to be done by another firm • Potential intervention by SRA if dishonesty suspicion arises	financial loss and distress and inconvenience (up to £50k) • If payment made by credit card and is between £100 and £30,000 s75 of Consumer Credit Act applies • Report to us and potential investigation for breach of our Accounts Rules, e.g. as the firm is not performing all instructions received from the client (standards in the Codes of Conduct) • Potential recovery of funds depending on application of statutory trust if the SRA intervenes and the funds are still available • Negligence claim • Claim on compensation fund (current position) as not doing work that has been paid for is seen as failure to account
A sole practitioner takes payments on account of costs and for payments to third parties for which the firm is liable for, such as Counsels fees from a range of clients. The total amount of the money so held in the firm's business account is in excess of £125,000 The sole practitioner subsequently become bankrupt and ceases working	• Several clients are left out of pocket and without the legal advice being received as they thought • The experts and other third parties are not paid and will have to be paid again by the client if the work is to be done for the client • Client potentially becomes an unsecured creditor	• Claim on Compensation Fund post closure for all amounts lost by clients (current position) • Negligence claim/ claim on PII • Redress mechanism via LeO for financial loss and distress and inconvenience (up to £50k) • If payment made by credit card and is between £100 and £30,000 s75 of Consumer Credit Act applies – could be part payment or instalments • Claim against bankrupt estate • Report to us and potential investigation for breach of our Accounts Rules as the firm is not safeguarding money belonging to clients or acting in the best duty of

		the client (standards in the Codes of Conduct). Solicitor would also have practicing certificate suspended due to bankruptcy
We intervene (close down) a 2 partner firm due to suspected dishonesty. Both partners have been transferring significant amounts client money (as now defined) – mainly probate funds and personal injury damages - from client account to pay for fictitious disbursements or for unjustifiable sums on account of costs. They have then used these amounts to pay for personal expenses that have no relation to the clients concerned	• Clients suffer losses • Firm does not do work • Inconvenience to client • Client becomes an unsecured creditor • Client loses money	• Claim on Compensation Fund post intervention for all amounts lost (current position) • Redress mechanism via LeO for financial loss and distress and inconvenience (up to £50k), payment by insurer in case of intervention • If payment made by credit card and is between £100 and £30,000 Section 75 of Consumer Credit Act applies • Statutory trust will apply for those where money is left at the point of intervention • Enforcement action after inspection due to dishonesty and failure to safeguard money and assets entrusted by the client

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Annex 1.5 - Indicative list of guidance areas and example case studies

Proposed areas of guidance - SRA Accounts Rules

1 Acting as a trustee and client money
2 What is client money
3 Name of client account
4 Withdrawals to make payments to Charity
5 Who can make withdrawals from client account?
6 Residual balances due to a client
7 Requirements to pay interest
7 Accounting records and systems
8 Accountant's Reports
9 Record keeping around operation of joint accounts
10 Operation of a client's own account
11 Treatment of legal aid money/monies received relating to formal appointments (insolvency)
12 Use of Third Party Managed Accounts
13 Client account as a banking facility
14 Waiver provisions
15 Out of scope monies in an MDP

Case study 1 - payment on account of costs

A client instructs Firm X in respect of his divorce. The firm informs the client that their likely fees in total are likely to be in the region of £2000 but may increase if further work is needed in respect of ancillary matters.

Firm X gives the client a full breakdown of the likely costs and expenses in dealing with the matter (in accordance with Standards 8.6 and 8.7 of the SRA Code of Conduct for Solicitors/Standard 7.1(b) of the SRA Code of Conduct for Firms). Firm X also advises the client about the protections that are available to him and confirm the same in the client care pack (in accordance with Standard 8.9 of the SRA Code of Conduct for Solicitors). The client makes a cash payment on account to the firm of £2000.

Firm X pay the sum (£2000) into their business account in accordance with the SRA Accounts Rules 2017. Firm X have an obligation to ensure that they safeguard money entrusted to them by the client (Standard 5.2 of the SRA Code of Conduct for Firms).

The client's matter runs smoothly and he and his wife are able to agree on many issues. On completion of the matter, Firm X deliver a bill to client confirming that the firm's total costs, including all expenses, come to £1200 plus VAT, a total of £1440.

The surplus £560 becomes client money as it is money held by Firm X relating to legal services they have delivered to the client but is not payment for the firm's fees or due to a third party. The firm ask the client for his bank details so that a BACS payment of the amount he is due to be refunded can be made.

In accordance with Rule 4.1 and 4.2, Firm X transfer the £560 from its business account into client account. The client then makes contact with Firm X and provides his bank details so that the £560 can be returned. Firm X, in accordance with Rule 2.4, promptly make the payment to the client.

Case study 2 - making prompt payments

Firm Y acts for a minor in suing a third party driver for significant injuries she suffered in a road traffic accident. The accident left the child's parents unscathed but she will need long term care and rehabilitation.

The driver's insurer admits liability and the firm agrees both a substantial award of damages (of £350,000) as well as payment of their legal costs in full. Despite a request that the insurer makes two payments, the insurers in fact make a single bank transfer for the entire amount into the firm's office account. After two weeks of chasing, the firm realise the mistake and, in accordance with Rule 6.1, immediately transfers the damages portion of the settlement to the client account. The client's parents are informed of what happened and ask for the damages to be sent to their daughter's account to fund payments they urgently need to make on her behalf.

Rule 2.4 requires firms to ensure that client money is returned promptly to the client as soon as there is no longer any proper reason to retain those funds. 'Promptly' is not a defined term and will depend on all the circumstances of the matter, the nature of the firm and the instructions received - underpinned by the obligation in the SRA Code of Conduct for Solicitors and Firms to ensure that money and assets are safeguarded and the SRA Principles including that they act in the client's best interests.

The lead solicitor, after speaking to his supervisor (who is also the firm's COFA), authorises an immediate return (on the same day instructions are received) of the client's money. Firm Y took into account the client's circumstances, the delay already encountered and the parents' need to have the monies as soon as possible to pay for the child's care. In addition they also consider their obligation under Rule 7 of the SRA Accounts Rules and pay to the client a fair amount of interest for the client money they had held.

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Initial Impact Assessment

Overall approach - assessing the impact

1. The Legal Services Act 2007 provides a common framework and set of objectives for all the legal services regulators and for the Legal Services Board (LSB), our oversight regulator. We must always have these in mind when we set the rules used to govern the conduct of the people and firms we regulate. These objectives are to:

    - protect and promote the public interest;
    - support the constitutional principle of the rule of law;
    - improve access to justice;
    - protect and promote the interests of consumers;
    - promote competition in the provision of services;
    - encourage an independent, strong, diverse and effective legal profession; and
    - increase public understanding of the citizens' legal rights and duties.

2. This statement considers the potential impacts on firms and consumers resulting from the changes we propose to the Accounts Rules and we have aimed to assess these changes with the regulatory objectives, the better regulation principles and our wider equalities duty in mind. Where we have identified possible adverse impacts arising from our proposals we explain the steps we will take to mitigate these. It may be that some impacts cannot be assessed due to a lack of information or because that an impact can only be realised once a policy has been implemented. We will therefore continue to review our data in respect of the number of reports received relating to a breach of the Accounts Rules and consider how firms can be supported through guidance and case studies that form part of the online toolkit.

3. As noted above, we have a regulatory objective to encourage an independent, strong, diverse and effective legal profession and also have to comply with our public sector equalities duty. We have not identified any data as part of this review which suggests any particular diversity impacts. We will therefore be engaging with firms and representative groups over the course of the consultation period to determine whether there are any specific impacts we need to consider and address.

4. The framework and rationale of our review of the Rules is designed to achieve the following:

    - remove unnecessary barriers and restrictions and enable increased competition, innovation and growth to better serve the consumers of legal services;

- reduce unnecessary regulatory burdens and cost on regulated firms ensure that regulation is properly targeted and proportionate for all solicitors and regulated businesses, particularly small firms; and,

- maintaining an appropriate level of consumer protection.

5. Key changes that are being consulted are to:

- Simplify the Accounts Rules by focusing on key principles and requirements for keeping client money safe, including:

    - keeping client money separate from firm money
    - ensuring client money is returned promptly at the end of a matter
    - using client money only for its intended purpose
    - proportionate requirements for firms to obtain an annual accountant's report

  This will put the focus on what is important and allow firms greater flexibility to manage their business and help consumers understand how their money will be protected. The Accounts Rules will also be simpler and easier to understand - increasing compliance and reducing compliance costs. A draft of the Accounts Rules is provided at Annex 1.1 of the consultation paper. As with the Codes of Conduct, the Accounts Rules will be supported by clear guidance, case studies and toolkits to aid compliance.

- Change the definition of client money to allow money paid for all fees and disbursements for which the solicitor is liable (for example counsel fees) to be treated as the firm's money. Money held for payments for which the client is liable, such as stamp duty land tax, will continue to be treated as client money and therefore required to be held in client account. The impact of the proposed change in definition is expected to remove the need to have a client account for some firms and therefore reduce the associated compliance costs. The changes may also reduce the number of firms required to obtain an accountant's report through the subsequent reduction in the client account balance.

- **Provide an alternative to the holding of client money:** through the introduction of clear and consistent safeguards around the use of third party managed accounts (TPMA) as a mechanism for managing payments and transactions.

This is our initial impact assessment which considers the impact of each key change on both firms and consumers. We will develop our final impact assessment as we consider responses to the consultation and decide next steps.

Key change 1 - simplification of the Accounts Rules

Impact on firms

6. The current Accounts Rules are prescriptive and complex. Rather than focusing on the key risks to client money they seek to mitigate those risks by prescribing how firms should run their accounting systems. As the Accounts Rules have developed over many years, much of this prescription has developed to address specific issues and is based upon traditional models of practice. This can make it difficult for new entrants to understand and comply with the Accounts Rules. Further, many firms find themselves in technical breach of the rules in circumstances where there are no real risks to client money. As highlighted in our earlier consultation[33] on reporting accountant's requirements, of the approximately 9000 firms that hold client money, in the period June 2012 to December 2013, over 50% received a qualified accountant's report but only 179 were consideration for further regulatory action[34].

7. We are proposing to remove the unnecessary prescription from the Rules, and reduce both the length and complexity. The draft Accounts Rules currently stand at 6 pages – down from 32 pages. A simpler set of Accounts Rules is not only easier to understand, particularly for new entrants, but more accessible for a range of different business models. This has the potential to remove a barrier for new entrants who at the moment may be so intimidated by the detail, length and complexity of the current Rules they are put off from SRA regulation altogether.

8. The proposed Accounts Rules provide greater flexibility to all providers. For example we have removed the prescriptive time limits for which money should be moved from one account to another. We often hear from firms that the current prescriptive time frames don't work. This is for different reasons - for firms in rural areas the current time limits may not be realistic - and for larger firms they may be far slower than what their clients expect.

9. In the longer term we envisage the simplicity of the Accounts Rules could reduce compliance costs for all providers - with less time spent on setting up specific systems and processes because they are required by our Rules rather than because they fit with the rest of the business and clients. For example - we have retained a requirement to ensure reconciliations are completed at least every 5 weeks. This is a minimum requirement which is an important mitigation to the risks to client money. But for many firms, particularly larger firms, reconciliations will be done more frequently (even daily) because that is what their business and clients expect. We envisage that the changes may also reduce the level of interaction that some firms have with the SRA in relation to technical breaches. This is something we will

[33] http://www.sra.org.uk/sra/consultations/reporting-accountant.page
[34] http://www.sra.org.uk/Solicitors_Regulation_Authority/sra/how-we-work/board/public_meetings/archive/SEP14_7_-_Reporting_Accountant_Requirements.pdf

need to consider as we develop the suite of guidance and case studies to support the Accounts Rules.

10. We have been engaging with firms as we develop our proposals and are keen to gather information as to the impacts of the changes on for example, type of firms by way of size or ethnic make up of firm personnel to inform our final impact assessment.

11. The proposed changes also impact on accountants and other personnel for example, Legal Cashiers - both in the role they may play within firms and in the role of reporting accountant. We have engaged closely with accountants throughout earlier phases of this review and have continued to do so as part of the third and final phase. The proposals to simplify the Accounts Rules will bring them into line with our expectations for reporting accountants to assess the real risks to client money (as opposed to identifying technical breaches) - introduced in Phase 2 of our review. We envisage this will make the role of the reporting accountant easier in the future.

Impact on consumers

12. As is the case under the current Accounts Rules, a firm's primary objective will be to ensure that client money and assets will be protected, and the firm has in place systems and procedures which ensure compliance with the rules so that client money is used only for that client's matter. This is reflected in both the Accounts Rules and the Code of Conduct for Solicitors and Code of Conduct for Firms. These obligations bite regardless of the size and makeup of the firm or other characteristics. The effective controls and procedures a firm has in place *should* act as an assurance for consumers and give them confidence that their funds will be kept safe.

13. Simpler rules will make it easier for consumers to understand the key principles for regulation in this area, in other words that client money and assets must be safeguarded. They also focus firms on addressing the real risks to client money.

14. We consider that the proposed Accounts Rules provide an important protection to consumers by safeguarding their money. We do not consider that our proposals reduce or dilute in any way the obligation on firms, their managers or employees to keep money safe. This helps demonstrate that we are acting in accordance with the objective to protect and promote the interests of consumers and support the constitutional principle of the rule of law.

15. The main consumer impacts relate to the key policy changes regarding the definition of client money and our proposal that firms may chose to offer the alternative of client money being held in a Third Party Managed Account (TPMA) - set out in the following sections.

Key change 2 - redefining client money

Impact on firms

16. As part of the Practising Certificate Renewal Exercise (PCRE) exercise for 2015/16, 7528 authorised firms declared that they held client money. These firms are all required to comply with the current Accounts Rules, and the associated costs of running a client account. While there are some benefits to firms in terms of interest and better banking terms the costs of running a client account are significant. Firms that hold client money are also required to make a contribution of over £500[35] to our compensation fund which provides a discretionary safety net in the event of dishonesty or a failure to account. The exact costs of complying with the Accounts Rules are difficult to quantify, however we know that approximately 6000 firms are required to obtain an Accountant's Report. We understand from practitioners that a small firm may pay around £800 for each annual accountant's report, but that larger firms may pay several thousand pounds[36]. As a proportionate regulator we need to consider whether these obligations can be justified. The changes we are proposing to the definition of client money will help ensure that the protections provided by the Accounts Rules apply only where needed.

17. If we proceed with the change in the definition of client money, it may be the case that some of these firms may no longer be holding client money – as more narrowly defined – and would no longer be required to have maintain a client account and therefore comply with the associated Accounts Rules. It is therefore envisaged that a reclassification of this type of money may lift a proportion of firms out of the cost and burden of regulation that come with the client account altogether. We do not have specific data which sets out the number of firms that currently hold client money in the form of payment on account of costs or professional disbursements so it is difficult to determine precisely how many firms may be affected in this way.

18. By redefining client money, it may be that there will be a change in the average and total client balances held by firms which is likely then to take more firms out of the need to obtain an accountant's report if the balance meets our exemption criteria[37].

19. In terms of professional disbursements falling outside the proposed definition of client money, it may be that some firms will have to review how they

[35] Under the SRA Fee Policy 2015/16, firms that hold client money are required to contribute £548 to the compensation fund. A flat fee of £32 is also payable by every individual solicitor/REL/RFL http://www.sra.org.uk/mysra/fees/fee-policy-2015-2016.page

[36] http://www.sra.org.uk/sra/consultations/reporting-accountant.page

[37] Phase one changes came into effect in October 2014 and introduced an exemption for firms where 100% of work is funded by legal aid from the need to obtain that report . We also removed the requirement for firms to submit to us reports where these found no failure to comply with the Rules. Phase two was implemented in November 2015, and encouraged reporting accountants to apply an outcomes-based approach to assessing compliance, with a greater focus on risks to client money. We also extended the exemption from the obligation to obtain an accountant's report to firms that have 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

engage with professional experts instructed on behalf of a client. The key point here is that the firm remains liable to the expert and not the client. For this reason these relationships can be differentiated from the relationship that a solicitor shares with their client and therefore, costs/monies due to these individuals do not need to be treated in the same way as money held on behalf of a client i.e. being ring fenced in client account . Many professionals will have engaged with firms previously when providing their services and will be in a better position to negotiate their terms of business. These terms, in our view, should not be determined by us and reflected in the Accounts Rules. The remaining indirect risk to clients through for example, payments to experts not being made promptly by the firm (to retain the funds in their business account to minimise an overdraft) is covered by broader obligations in the Codes of Conduct to act in the client's best interests and ensure that money and assets entrusted to the firm are properly safeguarded.

Impacts on firm systems and training

20. The legal services compliance market already provides online resource and bespoke IT packages to help firms and individuals comply with the Accounts Rules. Providers say that the aim of these facilities is to help firms:

- Update their systems and control procedures to improve compliance of the Accounts Rules; and,

- Adopt best practice with respect to the Accounts Rules.

21. For those firms that continue to hold client money, the change in definition is likely to impact on systems and processes in the short term as they make changes to their accounting systems to ensure only client money (as redefined) is continued to be paid into client account. However, in the longer term we anticipate this will provide firms with greater flexibility for managing their accounting systems and for some the opportunity to avoid the costs of managing a client account.

22. Simplifying the definition of client money should reduce costs or result in no material change in costs over the long term. It is envisaged that current systems will adapt as client money will still need to identified and held in accordance with the proposed Accounts Rules.

23. We are keen to engage with software, compliance and training suppliers in particular as to whether there is any information to help inform our final impact assessment.

Impact on consumers and consumer protection

24. Consumer confidence in the legal services market is underpinned by an expectation that client money will be safeguarded. This protection is primarily delivered through an obligation to comply with the Accounts Rules and thereby protecting and promoting the interests of consumers. The change in

definition is intended to target regulatory protections on the categories of client money where the risks are highest. We consider the proposed approach presents a better balance between regulatory burden and consumer protection.

25. We have explained in the consultation paper that we do not consider that there is a case for removing certain types of disbursements and costs, such as stamp duty land tax and Land Registry fees, from the definition of client money and the protections provided by the Accounts Rules. These liabilities can be significant and removing them from the definition of client money (and associated consumer protections) presents a significant risk to the consumer. This is supported by data from the Compensation Fund which shows the Fund paid out over £3m for these types of disbursements over the past two years. Our proposals to redefine client money will not change the protections[38] afforded to clients with regards to transactional monies and costs for which they (the client) is personally liable.

26. As we have explained in the consultation paper, our position on fees and proposal to treat fees paid in advance as the firm's own money relates in part to the range of consumer protections available to consumers outside of our regulation.

27. Consumer protection in legislation has improved substantially since the Accounts Rules were drafted. The Consumer Rights Act[39] provides consumers with statutory rights; to services to be performed with reasonable care and skill, to pay a reasonable price for a service and for services to be performed in a reasonable time. The Act also provides remedies including; claiming damages, seeking repeat performance and the right to a price reduction. The provisions relating to the supply of services consolidate various pieces of existing legislation and regulation and will apply to firms authorised by the SRA.

28. A change of definition of client money would not affect a consumer's ability to complain to the Legal Ombudsman (LeO) and to seek compensation, for instance if the work is not completed. The maximum level of compensation that can be paid out is £50,000, however, LeO also have the power to order a refund or reduction in legal fees up to a maximum of 100%.

29. Under Section 75 of the Consumer Credit Act, consumers that have paid by credit card can make a claim against their credit provider for; a breach of contract by the supplier of services, a lack of provision in part of in full of the services, or for not providing the services as specified; so long as the services were bought for between £100 and £30,000. These provisions apply to circumstances where a company becomes insolvent, leading to a non-receipt of the services. Via the Financial Ombudsman the protection of Section 75

[38] Section 85 Solicitors Act 1974 also provides an additional protection for client money held in a firm's client account by ensuring that the bank/building society cannot take money held in a client account to discharge any liability of the firm to the bank/building society.
[39] http://www.legislation.gov.uk/ukpga/2015/15/contents/enacted

can lead to full repayment and can also include additional statutory interest payments and costs due to inconvenience caused to the claimant. However, there are some transactions where Section 75 may not apply - these include where the payment has been made through an online payment service and where a third party is involved.

30. Some of the potential risks to consumers of the proposed change in definition are set out in the table at Annex 1.4 of the consultation paper. These examples also provide our assessment of how the consumer protections set out above might apply in practice. We therefore consider that on balance the risk of consumer detriment is more than mitigated by the potential redress mechanisms available, albeit we accept that these may take considerable time and determination for clients to pursue.

31. We acknowledge that the Accounts Rules cannot prevent dishonesty on the part of a solicitor (or his/her employee) or a failure in firm systems and controls that result in client monies being stolen or not accounted for. And the risk of dishonesty may be increased by the proposed change in definition (as firms will be able to request advance payment for fees and disbursements and not have to pay the money into client account).

32. In the case of intervention, our power to intervene into a firm and take control of all funds held by the firm remains unaffected irrespective of whether or not it is client money. The potential impact of the change in definition is that monies paid in advance for fees or other related payments for work that has not yet been done, will not be protected in the client account. In the majority of instances, the firm's own account is overdrawn at the point of intervention and this money is therefore lost. In those circumstances the client, if eligible, would be able to claim on the Compensation Fund (as it is not currently restricted to "client money").

33. As noted above, the potential detriment to consumers is therefore likely to be the ease of access to redress in the event that something goes wrong. However we need to look at this risk in the context of the firms we regulate. Data from 2014/15 shows that we carried out 93 interventions - less than 1% of all firms we regulate. This supports our view that it would disproportionate to design policy based on the risk that something goes wrong. Further, the data on interventions also reveals that the current detailed rules do not effectively mitigate against risks to client money. Close to half of interventions (46 of the 93) included breaches of the Accounts Rules as the grounds for the intervention. We have received £32m as result of these interventions and paid out £18.5m from the compensation fund to clients as a result of them .

34. It is expected that the impact on clients in terms of how transactional money is managed will not change, however, firms will need to ensure that clients are clearly informed about how other costs (such as payments made to pay Counsel) will be dealt with. Clients need to be in a position to make informed choices and how a firm engages with third parties on their behalf will inform those decisions.

35. We have taken enforcement action in a number of cases where firms have in breach of the current rules deliberately held payments received for unpaid professional disbursements in the business accounts than the client account or used them for other purposes. These cases include several cases we have brought before the Solicitors Disciplinary Tribunal (SDT). Most cases centre around firms, in financial difficulty, failing to use money that the firm has received from clients to pay the professionals involved. Instead and contrary to the Rules, the firms keep those funds in office account, sometimes for several years, to reduce the firm's overdraft to an acceptable level. We cannot find evidence of immediate impact upon clients in these circumstances (as opposed to the professional who remains unpaid) but there is risk of delay in progression of their matter. Removing unpaid professional disbursements from the definition of client money therefore constitutes a significant change from our current approach and we will consider the impact on consumers by emphasising the duty of all solicitors to act in accordance with the Principles and standards in the Code of Conduct for Solicitors.

36. In cases where a firm or sole practitioner becomes insolvent (and the SRA has not intervened and taken control of both client and practice money) the administrator or trustee in bankruptcy has no jurisdiction over client account and there should be no question of the administrator/trustee in bankruptcy being able to use it for creditors. There is a potential risk that the administrator/trustee in bankruptcy may try to exert a claim on monies that were paid on account of fees and disbursements (for work not yet done) that would now, having regard to the proposed definition of client money be held in the firm's business account. In these circumstances, the client may be able to apply to the Compensation Fund (depending on eligibility to make a claim) but the original money which was paid to the firm may have gone to pay the administrator/trustee in bankruptcy first and then the creditors and so the Compensation Fund will be in effect subsidising those two categories.

Key change 3- permitting authorised firms to use alternatives to holding client money such as third party managed accounts (TPMA)

37. We are proposing rules that will allow solicitors in SRA authorised firms to use Third Party Managed Accounts (TPMA) as an alternative to holding client money.

38. Those Rules would permit entities to use a TPMA where the firm could demonstrate:

a) the TPMA is either an authorised payment institution and a result has mandatory safeguarding arrangements , or is a small payment institution which has adopted voluntary safeguarding arrangements; and,
b) they can demonstrate that the firm has suitable arrangements for the implementation, use and monitoring of TPMAs. For example that use of TPMAs is suitable for the types of transactions, appropriate

information is provided to clients and appropriate internal controls are in place.

Impact on firms

39. The success of the TPMA market will depend on TPMA providers offering a service in a way that is commercially attractive to firms (and their clients) as an alternative to holding a client account, and which offers sufficient speed and security of transactions. It is envisaged that small firms and new entrants are most likely to take advantage of TPMA as this removes the cost of operating a client account and shifts the associated regulatory obligations on to the TPMA provider to ensure that money is kept safe. Large and medium sized firms may also consider using TPMA where they only occasionally hold client money.

40. By allowing firms to hold client money in a TPMA it is envisaged that this will help achieve the regulatory objective that our arrangements promote competition in the provision of legal services. Firms will be able deploy resource to build robust business models and allow clients the choice of how their money should be held. Historically, small firms and sole practitioners have been associated with the risks of holding client money - holding money in a TPMA may over time remove that association and allow small firms to compete in a market that allows for innovation and flexibility in approach. Several insurers have indicated that they welcome the use of TPMA as a mechanism for reducing their risk. We are keen to hear from insurers as to whether firms that hold client money in a TPMA will see a reduction in insurance premiums.

Impact on consumers

41. A consistent risk to consumers is the misuse of client money. The availability of TPMAs may offer improved security and protection for consumers. The very nature of a TPMA, by definition, is that the client is a third party to the account and therefore has the ability to approve transactions or to withdraw their money when needed. It is our working assumption that the compensation fund would not apply in relation to TPMAs.

42. We are seeking to mitigate any risks to the consumer by requiring firms to use TPMA which are either an authorised payment institution (and as a result has mandatory safeguarding arrangements), or is a small payment institution which has adopted voluntary safeguarding arrangements (set out in more detail in the main consultation document). We will also introduce requirements to ensure sufficient information is provided to the client, especially prior to entering into a TPMA arrangement, and to ensure a clear understanding of the terms of the contract including their right to terminate.