Client Money Digest

February 2024

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DEFERRAL OF AMENDMENT TO SRA ACCOUNTS RULES

The Solicitors Regulation Authority ("SRA") has made a number of minor changes to their Standards and Regulations following a consultation and approval from the Legal Services Board (LSB).

However, regarding proposed amendments to the SRA Accounts Rules, which were set out in the response to the consultation, the SRA's Press Release highlights the following:

"Accounts Rules changes:

In light of recent events, including Axiom and a general increase in the number and size of interventions, we have decided that it is necessary to review our consumer protection arrangements. This includes reviewing risks to client money and the effectiveness of our current arrangements for protecting against them. We have reflected carefully and do not feel that it is the right time to make minor changes to the Accounts Rules while we are reviewing these wider issues.

If we do not change our policy on our Accounts Rules following this review, we then plan to seek approval for these minor changes."

HAT RESPONSE
Once amendments have been finalised by the SRA, time will be set aside to update the HAT SRA Accounts Rules methodology.

SRA INTERVENTION FOLLOWING SRA ACCOUNTS RULES BREACHES

The SRA has intervened into Axiom Ince, a firm of solicitors and their Press Release includes the following:

"There has been widespread attention following our decision to intervene into Axiom Ince and the potential impacts for the public and the profession. As there are ongoing investigations – and any allegations are as yet unproven – we are limited into how much detail we can go into about this case. However, we thought it would be useful to clarify some key points about the case and reflect on some of the issues it raises.

The first Axiom intervention:

We first intervened on grounds of suspected dishonesty and breaches of the SRA Solicitors Accounts Rules. The sole shareholder at the firm, was suspected of misusing significant amounts of client money, resulting in an account shortage estimated to be more than £60 million.

So, on 10 August 2023, we closed down this practice and that of two other directors of the firm. We also referred the issue to the relevant law enforcement agencies, and the Serious Fraud Office has now announced an investigation and that it has made arrests.

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When we identified the issue:

The suspected dishonesty and missing client money was uncovered in late July. This was a result of a visit by our forensic investigation team, and further digging behind what on the face of it looked like well-ordered accounts. The nature of the suspected dishonesty was sophisticated and included falsified bank statements and letters.

At this point in time – apart from any individuals who may have been complicit – no one was aware of or identified issues with the client account. This includes partners in the firm, accountants, banks or auditors – it was not raised in any of the accountant's reports.

Like any firm of a reasonable size, we have had a number of complaints about Axiom over the years. Yet nothing out of the ordinary. We visited the firm last year to investigate a self-report by the firm about another solicitor in relation to immigration work, but neither this complaint – nor any others – were linked to the issues we uncovered with the client account or the suspected dishonesty that led to the intervention.

Axiom's takeover of other firms:

This year Axiom carried out two takeovers of firms who had entered administration: in April it took over Ince Gordon Dadds and in early July Plexus Legal. A takeover can be beneficial for clients and the wider public. For instance, if a firm is on the brink of collapse, then a takeover can make sure clients' matters continue to be dealt with, avoiding a disorderly closure where we have to intervene into the firm.

Yet takeovers can also result in new or increased risks to clients. Firms must notify us if a takeover has happened. We then assess on a case-by-case basis the risks of that takeover, what assurances we might need and actions we may need to take to protect the public. For instance, we have the power to impose conditions on how a firm operates, and to refuse or restrict the approval of role holders within the firm.

In this case, it was unusual that Axiom was taking over a larger firm, Ince Gordon Dadds, which was also doing specialist work, shipping law, which Axiom was not experienced in. Therefore, we visited the firm to check all was in order and assess whether we needed to take further steps to manage risks. This is when we identified the issue of the significant shortage in the client account.

Intervening into the whole firm:

We took prompt action to protect the public by intervening into the practices of three of the firm's directors. This intervention removed the immediate possibility of ongoing harm to the public and the firm's clients. The missing money meant that it was not going to be possible for the whole firm to carry on operating in the long term, but it was not in the interests of clients to close the whole firm down immediately.

We liaised with the remaining directors to make sure they were working in the best interest of their clients and to achieve as orderly a closure as possible in the circumstances. The firm announced its intention to call in the administrators on 1 October and as it would no longer deliver legal services effectively to its clients, we stepped in to protect them, intervening into the rest of the firm on 2 October 2023.

The short-term impacts:

This case is the biggest intervention ever in England and Wales. The number of interventions has more than doubled this year. This raises questions about the issue of consumer protection and specifically the role of the compensation fund. A discretionary fund of last resort – paid for by the whole profession – it provides a vital safety net for clients where a solicitor has stolen or not accounted for client money and is not covered by a firm's professional indemnity insurance.

In the short term, we are working through the best way to compensate current claims while also ensuring the fund remains financially viable. More widely, we are seeing a pattern of increased claims on the fund, so although we have not made any decision about what this means for a collection of funds from the profession, it looks likely that, after years of keeping them stable, we will need to increase levies.

Longer-term impacts:

In the longer term our overall policy towards consumer protection will need a wider discussion once the immediate priorities have been resolved. We know from our consultations on the future of the Solicitors Indemnity Fund in 2021/22 that the profession and other stakeholders have all told us how important consumer protection is to trust and confidence in legal services but we also hear the concerns being expressed about the costs to and impact on the profession."

The SRA subsequently issued a further Press Release relating to the compensation fund and this included:

"We will not be imposing an overall cap on claims against the compensation fund arising from Axiom Ince and those claims will be prioritised to make sure that the most pressing – such as for domestic conveyancing – will be dealt with first in order to maintain the financial solvency of the fund. By managing the cashflow demands on the fund, we will not call on solicitors to make an in-year contribution at this point.

The fund was set up to protect consumers of legal services and to maintain trust and confidence in the profession. Its purpose statement specifically refers to 'financial loss due to fundamental ethical failures – such as dishonesty or lack of integrity of solicitors'.

The rules of the compensation fund enable us to impose a discretionary £5m overall cap on claims from an intervention as a method of protecting the solvency of the fund. The idea of a cap was introduced some years ago and in a different context - that of investment scheme fraud. It was against that backdrop that the cap was set at a fixed level of £5m, which we cannot raise or lower, but the fund rules allow us to use our judgement to impose the cap dependent on the circumstances of the case.

In the case of Axiom, the scale of consumer loss, were the cap to be applied, would be too large, and would lead to an unacceptable loss in public confidence in solicitors. By adopting a careful prioritisation approach to the settling of claims, our aim is to manage the fund's short-term solvency and avoid extreme consumer detriment.

Given the increasing number and size of interventions in recent years, there is a longer-term question about the compensation fund and consumer protection more generally. We will be considering whether we can reduce the risk of similar firm failures in the future and will consider what part, if any, a cap can or should play in our client protection arrangements while making sure that protection is viable and proportionate in the long term.

Since the intervention, we have only paid out a limited number of emergency claims against strict criteria, such as where there was a risk of homelessness or imminent insolvency, or if a client was under a contractual obligation to complete on a private domestic property purchase. Now that a decision has been taken not to impose a cap, these criteria have been developed into detailed guidance for claimants that explain the process and provide an indication of timescales for claims to be considered.

To date, we have received claims totalling approximately £33m. A claim against Axiom Ince's professional indemnity insurance is under way and the level of funds which may be recovered from the existing freezing order on assets obtained by the firm is still to be determined. If funds are recovered from the insurance claim or from the sale of frozen assets, these will be used to replenish the compensation fund."

SRA GUIDANCE ON ACCOUNTANTS' REPORTS

The SRA has advised the following in respect of Accountants' Reports:

"Solicitors hold positions of great trust as they hold client money, often in large amounts. Our Accounts Rules are there to provide a framework to protect client money and make sure it is not put at risk.

Any firm that has an active client account has an obligation under Rule 12 to:

- Obtain an accountant's report for that accounting period within six months of the end of the period; and
- Deliver it to us within six months of the end of the accounting period if the accountant's report is qualified to show a failure to comply with these rules, such that money belonging to clients or third parties is, or has been, or is likely to be placed, at risk.

We are concerned that some firms are failing to uphold either or both of these rules when there is no reason for a reputable, well-run practice to do so. A breach of these rules could lead to disciplinary action."

ACTION FOR FIRMS
It is advisable that when an Accountants' Report is qualified, that the Reporting Accountant obtains a copy of the submission receipt for their file to confirm that the qualified report has been received by the SRA.

SRA GUIDANCE ON HANDLING CLIENT MONEY

The SRA has issued two pieces of guidance in respect of funds held by solicitors on behalf of clients and in each case, their guidance states:

Provision of banking facilities:

"The SRA Accounts Rules include Rule 3.3, which states solicitors 'must not use a client account to provide banking facilities to clients or third parties. Payments into, and transfers or withdrawals … must be in respect of the delivery of regulated services'. This rule was introduced initially in 2004 to specifically address the problem that some law firms were providing clients with banking facilities when they did not have access to one.

We published case studies to help law firms understand the types of instances when paying money into the client account is not acceptable. These have now been updated with additional scenarios to give firms more guidance.

These case studies give firms an idea of the type of issues they might be confronted with. However, we have cautioned firms that any case will turn on its own individual facts.

There are a range of risks of using a client account as a banking facility – it could facilitate money laundering, help someone avoid their obligations in an insolvency situation, or improperly hide assets in a commercial or matrimonial dispute. The SRA has also warned firms about the risks of allowing firms' client accounts to be used to add credibility to questionable investment schemes.

Firms cannot justify processing money through the client account due to having a retainer with a client. Nor should they hold funds to enable them to pay a client's routine outgoings, for instance when based abroad. Online banking developments mean this is no longer justifiable."

Holding money on a client's behalf:

"A number of firms have approached us for guidance where the client has approached them asking them to hold monies on their behalf, but they do not wish to do so. We have therefore added this – and our response – to our client account Q&As."

SRA ACTION REGARDING RESIDUAL BALANCES AND BANKING FACILITIES

The SRA has fined a London solicitors' practice £14,116 following an investigation which identified that the practice:

- Did not have and / or failed to implement adequate procedures to deal with residual client balances on inactive or closed matters;
- Used systems and processes that did not identify and allocate unidentified receipts in client account;
- Used its client account as a banking facility; and
- Used its client account to retain rent deposits when it no longer carried out legal services connected to the rent deposits.

The practice reported itself to the SRA in the autumn of 2021 and the findings published by the SRA in the decision notice include the following detail:

- Between July 2008 and October 2021, there were inadequate procedures to deal with residual client balances on inactive or completed matters, which totalled £104,967 on 15 October 2021, despite a requirement for funds to be returned at the end of a matter and for there to be annual communication of the retention of funds after this time. The SRA highlighted that had such letters been sent, this may have raised a "red flag";

- Between October 2013 and October 2021, there were unidentified receipts into the client account resulting in a suspense ledger building up an unresolved balance of £34,454 in April 2021, despite a requirement to have effective systems in place to ensure that accounting records are properly written up at all times;
- Between May 2011 and October 2021, the client account was permitted to receive, hold and transfer funds in relation to rent and rent deposits, where these did not relate to an underlying transaction or regulated service provided by the practice, despite the SRA Accounts Rules being clear that banking services cannot be provided; and
- From February 2010, the client account was used to retain rent deposits on 25 matters, which amounted to £103,000, where the retention was no longer connected to the practice's delivery of legal services, again, despite the prohibition on the provision of banking services in the SRA Accounts Rules.

As the practice generally had good accounting records, the quantum of funds noted above which were paid to charity, where it was not possible for clients to be traced amounted to just £858. However, given that these problems continued for a significant period of time, there was only a 15% reduction in the level of financial penalty levied on the practice.

ACTION FOR FIRMS
Where there are significant breaches of the SRA Accounts Rules and / or significant weaknesses in a solicitors' systems and controls, the Accountant's Report to the SRA must be qualified.

FCA FEEDBACK ON CASS REPORTS

At a recent session hosted by ICAEW, a representative from the Financial Conduct Authority ("FCA") provided feedback relating to Client Assets Reports which they receive.

The FCA receive around 3,200 Client Assets Reports per annum and these cover entities which hold £16 trillion of custody assets and £195 billion of client money. On receipt, all Client Assets Reports are reviewed and triaged according to the risks identified. As many reasonable assurance Client Assets Reports are modified, it is possible that an unmodified opinion on a reasonable assurance assignment could be viewed as a higher risk scenario.

The key problem with audit quality which is experienced by the FCA relates to the drafting of Client Assets Reports and their observations in this area include:

- Lack of detail regarding items included in the breaches schedule which accompanies a reasonable assurance report and / or a lack of management comment regarding the identified breaches;
- Not all breaches being included in the breaches schedule, in particular, where there is a modification of the opinion relating to compliance at the period end, that this is not carried over as an "automatic" modification of the opinion for the following period; and
- When it will not be possible for the Client Assets Report to be provided to the FCA prior to the deadline for submission, there is not always timely notification of the delay and the reasons for these, as required by SUP 3.10.8.

On performing analysis of the audit firms which contribute to the above problems, the FCA regularly find that such firms only prepare a very small number of Client Assets Reports annually and as such, there may be concerns regarding competence. In the event of significant concerns about a particular Statutory Auditor, the FCA makes a complaint to that firm's professional body.

ACTION FOR FIRMS
To guard against regulatory risk, ensure that all team members involved in preparing a Client Assets Report have received adequate training.

FINANCIAL SERVICES AND MARKETS ACT 2023

The Financial Services and Markets Bill has received Royal Assent and the Government has summarised its impact in the following Press Release:

"The Financial Services and Markets Act 2023 is central to delivering the Government's vision to grow the economy and create an open, sustainable, and technologically advanced financial services sector.

It seizes the opportunities of Brexit by tailoring financial services regulation to fit UK markets. The Act bolsters the competitiveness of the UK as a global financial centre and delivers better outcomes for consumers and businesses.

It contains new powers – available due to Brexit – that will set the path for reforms to Solvency II, which will unlock around £100 billion for productive investment and help cultivate innovation and grow the economy.

The Act also introduces new secondary objectives for the Financial Conduct Authority and the Prudential Regulation Authority – to facilitate the growth and international competitiveness of the UK economy. This will be backed up by changes to enhance the scrutiny and accountability of the regulators, including ensuring regular reporting and a greater focus on cost-benefit analyses.

The ground-breaking Act also:

- Enhances the scrutiny of the financial services regulators to ensure clear accountability, appropriate democratic input, and transparent oversight;
- Removes unnecessary restrictions on wholesale markets – implementing the key outcomes of the Wholesale Markets Review;
- Protects free access to cash in law and introduces crucial protections for victims of Authorised Push Payment scams;
- Enables the regulation of crypto-assets to support their safe adoption in the UK; and
- Establishes 'sandboxes' that can facilitate the use of new technologies such as blockchain in financial markets."

HAT RESPONSE
HAT will monitor any amendments to the FCA Handbook to identify whether these impact the HAT FCA Client Assets Reports methodology.

FCA CLARIFICATION ON TRAVEL RULE FOR CRYPTO-BUSINESSES

The FCA has set out their expectations for UK cryptoasset businesses complying with the Travel Rule and their Press Release states:

"From 1 September 2023, cryptoasset businesses in the UK will be required to collect, verify and share information about cryptoasset transfers, known as the 'Travel Rule'.

The Financial Action Task Force ("FATF") has called on other jurisdictions to swiftly implement the Travel Rule, which aligns practices for cryptoasset businesses sending and receiving transactions with those common in other areas of financial services. In June 2023, FATF highlighted the challenges arising from delays in adoption and different timelines for enforcement of the Travel Rule across jurisdictions. We have worked closely with industry to provide guidance on how to comply and what we reasonably expect of firms ahead of other countries following the UK's position.

Our expectations for firms include:

- Take all reasonable steps and exercise all due diligence to comply with the Travel Rule;
- Firms remain responsible for achieving compliance with the Travel Rule, even when using third-party suppliers;
- Fully comply with the Travel Rule when sending or receiving a cryptoasset transfer to a firm that is in the UK, or any jurisdiction that has implemented the Travel Rule; and

- Regularly review the implementation status of the Travel Rule in other jurisdictions and adapt business processes as appropriate.

When sending a cryptoasset transfer to a jurisdiction without the Travel Rule:

- Take all reasonable steps to establish whether the firm can receive the required information; and
- If the firm cannot receive the necessary information, the UK cryptoasset business must still collect and verify the information as required by the Money Laundering Regulations (MLRs) and should store that information before making the cryptoasset transfer.

When receiving a cryptoasset transfer from a jurisdiction without the Travel Rule:

- If the cryptoasset transfer has missing or incomplete information, UK cryptoasset businesses must consider the countries in which the firm operates and the status of the Travel Rule in those countries; and
- The UK cryptoasset business should take these factors into account when making a risk-based assessment of whether to make the cryptoassets available to the beneficiary.

We will keep our expectations under regular review as global adoption of the Travel Rule develops and we will communicate any changes accordingly."

HAT COURSE DATES

To ensure that all members of your team who deal with assurance assignments in respect of client money are fully trained, the following CPD courses can be attended:

- SRA Accounts Rules in Practice – A Guide for Reporting Accountants ~ Tuesday 19 March 2024 (online course);
- Introduction to SRA Accounts Rules Assignments ~ Tuesday 16 April 2024 (Central London); and
- Acting for FCA Regulated Firms ~ recording available.

These CPD courses may alternatively be run, "in-house" for a firm on a mutually convenient date during 2024. CPD courses relating to Service Charges and Property Agents' Client Money also able to be provided, subject to demand.

For details of our charges and availability, please contact Bertie Townsend at the HAT Office at bertie@hatgroup.co.uk.

HAT ASSURANCE METHODOLOGIES

There have been no amendments to any of the HAT documentation covering client money assignments in the last year. Such documentation covers:

- FCA Client Assets Reports;
- SRA Accounts Rules Accountants' Reports; and
- Property Agents Client Money Assignments.

When performing an assignment to provide an Accountant's Report to Propertymark, it should be noted that there have been cosmetic amendments during 2022 to both the rules and the Accountant's Report. A detailed review has been performed and no amendment is required to the HAT Property Agents Client Money methodology.

ACTION FOR FIRMS
When completing a Propertymark Accountant's Report, ensure that the updated pro-forma report is utilised.

Additionally, it should be noted that, following the introduction of ISQM (UK) 1, where an engagement quality review ("EQR") is performed on a reasonable assurance assignment on a Large / Medium CASS investment business firm, this should be performed in accordance with the enhanced requirements of ISQM (UK) 2.

ACTION FOR FIRMS
Note that other than when an EQR is mandatory, a hot review does not need to be performed in accordance with ISQM (UK) 2.

IMPORTANT NOTE

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