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CLIENT MONEY NEWSLETTER

February 2016

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AMENDMENT TO ACCOUNTANT'S REPORT REQUIREMENTS:

Return to contents

There was an announcement by the Solicitors Regulation Authority ("SRA") on 15 July 2015 regarding proposed amendments to the SRA Accounts Rules 2011, which were subsequently approved by the Legal Services Board. The amendments (insofar as Reporting Accountants are concerned) only affect accounting periods ending on or after 1 November 2015, with the primary amendments being as follows:

- Firms having an average client account balance during the year of less than £10,000 (per the bank statements / building society passbooks) and where the maximum balance during the year is less than £250,000 will not be required to obtain an Accountant's Report (note that a "cease to hold report" will be required to be obtained and submitted in all circumstances);

Contents

- The Rules no longer set out the scope of the Reporting Accountant's test procedures, nor provide a Reporting Accountant's Checklist to be completed, although commentary from the SRA indicates that the scope (determined by the Reporting Accountant) should include consideration of the following:

    - The segregation of client and office monies;
    - A robust system of controls and checks to ensure accuracy and protect against fraud;
    - Effective oversight by management;
    - Appropriate authorisation of transfers and payments out of client account;
    - Ledgers and other entries are maintained on a timely basis;
    - An appropriately designed double entry accounting system;
    - That proper office and client bank account reconciliations are performed; and
    - Controls over incoming funds.

- The Accountant's Report is only required to include **material** breaches of the Rules;

- Rule 35 has been amended (such that where the Reporting Accountant is aware that a qualified report has not been submitted to the SRA, this is a whistleblowing obligation), meaning that the letter of engagement is required to be amended on the first assignment which falls within the amended Rules.

The main change for Reporting Accountants will be to determine whether breaches should lead to a qualification of the Accountant's Report, as the threshold for inclusion is now **material** breaches. Additionally, the form that solicitors' accountants complete each year has also been changed to make use of accountants' expert analysis. The new forms enable accountants to advise on areas of potential improvement in processes for handling client money, helping to support the form. The new guidance explains the changes, including outlining what would be regarded as being a material breach, and hence a matter for which the Accountant's Report would be qualified.

For those firms that still have the obligation to obtain a report, the changes strengthen the reports by giving accountants more scope to advise firms on how they handle client money. That will help clients and build confidence in law firms. The guidance sets out what accountants need to consider in their report, factors that might lead to the report being submitted to the SRA, and examples of the types of checks that may be undertaken by the accountants.

Regarding the scope of the Reporting Accountant's work following these amendments, HAT's view is that if the solicitor has a strong internal control system, supported by either a full time COFA or an internal audit department, where test checks are undertaken regarding compliance with the SRA Accounts Rules 2011, it may be possible to review and rely upon their work and for the Reporting Accountant to reduce the level of testing which they perform. In other circumstances (which HAT expects to be the case for most assignments), HAT recommends few, if any, amendments to procedures which have historically been performed.

Amending accountants' reports was one of the first strands of work in the regulatory reform programme launched by the SRA in May 2014 aimed at reducing the burdens

on firms without reducing the protection for consumers of legal services. The first phase of the project saw removal of the need for firms to deliver unqualified reports (i.e. those where no breaches of the rules were identified) to the SRA and of the need for those firms that receive all of their fees from Legal Aid to obtain reports in the first place.

A third phase, currently being developed, began in the autumn of 2015, and will look at simplifying the Accounts Rules themselves.

TECH 16/15 AAF ~ SRA ACCOUNTS RULES: INTERIM GUIDANCE FOR REPORTING ACCOUNTANTS FOLLOWING CHANGES TO THE ACCOUNTANT'S REPORT REQUIREMENTS: Return to contents

Further to amendments made by the SRA in respect of Accountant's Reports, for accounting periods ending on or after 1 November 2015, the ICAEW's Audit and Assurance Faculty has issued guidance on the conduct of such assignments under the new regime. The primary reason for this guidance appears to be as a result of "Rule 39", which set out in detail the test procedures to be performed, being withdrawn from the Rules. The Reporting Accountant is now required (in accordance with the new Rule 38) to use their professional judgment on the extent of procedures to be performed.

HAT has reviewed the guidance which has been published, and have concluded that in all material respects, the HAT SRA Accounts Rules 2011 Manual (November 2015) is in accordance with the guidance which has subsequently been issued by the ICAEW. Indeed, paragraph 33 of the guidance states, "many Reporting Accountants have been working with a risk based approach for a number of years and so will not be doing anything very different, other than making a decision as to the items of non-compliance to include on the AR1 Accountant's Report form, and those which are for management and / or the COFA / COLP".

The guidance is set out in two main sections. Initially, there is a commentary on the revisions which have been made to the SRA Accounts Rules 2011, which helpfully also sets out the SRA's position regarding concerns which the Reporting Accountant may have, which include:

- The SRA has re-iterated that it is not seeking any change in the responsibility or risk to Reporting Accountants in performing SRA Accounts Rules work, and highlight historical evidence which shows it is rare for the SRA to take action against a Reporting Accountant unless there are blatant / deliberate deficiencies in their work, or they are complicit in fraud (paragraph 38);

- The SRA has further indicated that typically, on average, there are less than ten occasions a year where they would contact a Reporting Accountant and question the quality and nature of the work that they have undertaken, which is usually where the Reporting Accountant failed to report any of the following to the SRA:

    - A lack of existence of any reconciliation of client funds;

- Unresolved shortages on client funds;
- Uncleared lodgements on the client account reconciliations; or
- Evidence of fraud (paragraph 39).

- Reporting Accountants should be able to demonstrate:

  - The breadth of experience of the team undertaking the work;
  - The strength of the planning process (including understanding systems and controls that the law firm has in place);
  - Training;
  - Work programmes;
  - Review process; and
  - The quality of conclusions (paragraph 42).

- Although not exhaustive, if the Reporting Accountant can demonstrate the above, the SRA is unlikely to take the view that the work performed and conclusions reached were inadequate in the event that the law firm, or the SRA subsequently identifies a risk to, or actual loss of client funds in the law firm concerned (paragraph 43);

- There is an education process here [regarding qualified Accountant's Reports] for COFAs and law firms; primarily that an unqualified Accountant's Report does not necessarily mean that the Reporting Accountant has not been in contact with the SRA [from a whistle-blowing perspective] surrounding the Report (paragraph 72).

Secondly, the guidance suggests that the following are the practical implications for the Reporting Accountant (many of which have historically been included within the HAT SRA Accounts Rules 2011 Manual, even though strictly, they were not all required to achieve compliance with Rule 39, and all of which have already been incorporated into the November 2015 Manual):

- Developing risk assessment procedures, including consideration of controls within the system;

- Drafting a planning memorandum, including having an engagement team planning meeting, and having contact with the client during the planning stage of the assignment;

- Creating a tailored work programme;

- Considering whether there is any requirement to whistle-blow to the SRA;

- Determining whether breaches which have been identified are material, and as such should lead to a qualification of the Accountant's Report; and

- Ensuring engagement terms have been amended to reflect the revision to Rule 35.

In addition to guidance on the conduct of the assignment, the Appendices within the Technical Release also reproduce extracts from the SRA's "Guidance on completing

the new annual accountant's report (AR1 form)", links to which are included within the HAT SRA Accounts Rules 2011 Manual.

FRC ASSURANCE STANDARD: PROVIDING ASSURANCE ON CLIENT ASSETS TO THE FCA: Return to contents

The Financial Reporting Council ("FRC") has published a Standard for audit firms on *Providing Assurance on Client Assets to the Financial Conduct Authority.* Its Press Release states:

"The Assurance Standard covers the work auditors do when reporting to the Financial Conduct Authority ("FCA") on the compliance by financial services firms, with the FCA's Client Asset ("CASS") rules. These provide for the effective safekeeping of client assets and client monies. More than 1,500 firms hold more than £100 billion of client assets and £11 trillion of other custody assets.

The FCA has recently strengthened its client asset regime. The Assurance Standard will help ensure that the strengthened regime is underpinned by sound assurance.

The development of the Standard, which will apply to periods starting on or after 1 January 2016 *[with early adoption permitted]*, has been supported by the FCA."

The wording used in the Assurance Standard is "aligned" with that used in the clarified ISAs, in that the word "shall" is extensively used, and as such, any concept of certain requirements being optional is removed. Material changes which will affect users of the HAT FCA Client Assets Reports Manual are:

- An Engagement Quality Control Review becomes mandatory in respect of all Reasonable Assurance assignments;

- There are many explicit requirements to make enquiries of management as part of the information gathering (including the operation of the client's compliance function), such that it would be practical for this to be dealt with via a pre-planning meeting;

- There are explicit and extensive requirements to be discussed in an engagement team meeting; and

- The extent of procedures to be performed (and suggested wording for a "letter") when an insurance intermediary holds client money in a non-statutory trust account is included within the Standard.

Time will be scheduled during 2016 to update the HAT FCA Client Assets Report Manual, although other than as noted above, as the current Manual includes "best practice" measures, not included in Bulletin 2011 / 2, making these requirements mandatory will not have any impact on the content of the existing Manual.

UPDATED FCA HANDBOOK / REGISTER: Return to contents

The Financial Conduct Authority ("FCA") has issued separate Press Releases advising that they are relaunching both the FCA Handbook and the FCA Register. These state:

"The new Handbook website has:

- A cleaner layout and easier navigation;
- A timeline so you can see when rules changed;
- An option to add favourites so you can build your own tailored Handbook;
- Improved search; and
- Glossary definitions displayed in a pop-up window.

As this is a new website, some of the links from other FCA systems will work differently - for example, they may not always link directly to a specific section of the Handbook, but be directed via the home page. Please bear with us as the changes take place - we will be monitoring the site closely to address any issues, but hope you will find it much improved."

"**Financial Services Register**

The new Register will have one search field to help you find a firm, individual or collective investment scheme by looking up its name, reference number or postcode. You will also be able to search for certain investment exchanges.

You will then be able to filter the search results or click on a name for further information like contact details, the permissions a firm has or whether it is covered by the Financial Ombudsman Service and Financial Services Compensation Scheme (FSCS).

The new Register also includes clearer language and help text to explain some important financial, technical and regulatory terms.

Unauthorised firms:

Firms that we have been told are providing regulated products or services without the required authorisation – or are knowingly running a scam – will be included in the Register for the first time.

These firms will be highlighted in search results by red text and a warning symbol to make clear that we think you should avoid dealing with them or individuals involved.

Further information on unauthorised firms includes the different details being given out and whether they are falsely claiming to be from a genuine, authorised firm.

Consumer credit firms:

Search results on the new Financial Services Register will include consumer credit firms that have interim permission, so you won't have to search the Consumer Credit Interim Permission Register separately.

Other registers

The Mutuals Public Register and Regulated Covered Bonds Register are not included in the new Financial Services Register. You can continue to search these registers separately."

FCA FINE OF £126M FOR BREACH OF CASS SOURCEBOOK: Return to contents

The FCA has levied a fine of £126m in respect of breaches of the Client Assets rules within the FCA / FSA Handbook. Their Press Release announcing the penalty states:

"The FCA has fined The Bank of New York Mellon London Branch (BNYMLB) and The Bank of New York Mellon International Limited (BNYMIL) (together 'the Firms') £126 million for failing to comply with the FCA Client Assets Sourcebook (Custody Rules, or CASS), which applies to safe custody assets and to client money.

The Custody Rules are there to protect safe custody assets if a firm becomes insolvent and to ensure those assets can be returned to clients as quickly and easily as possible. Each regulated firm is required to ensure they have adequate systems, controls and records to facilitate this. The Firms' failure to comply with the rules, including their failure to adequately record, reconcile and protect safe custody assets was particularly serious given the systemically important nature of the Firms and the fact that safeguarding assets is core to their business.

Had the Firms become insolvent, the total value of safe custody assets at risk would have been significant. This is compounded by the fact that the breaches took place at a time when there was considerable stress in the market.

The size of the fine reflects the value of safe custody assets held by the Firms as well as the seriousness of the failings and the fact that these failings were not identified by the Firms' own compliance monitoring. Other firms with responsibility for client assets should take this as a further warning that there is no excuse for failing to safeguard client assets and to ensure their own processes comply with our rules.

The Bank of New York Mellon Group (the BNY Mellon Group), of which the Firms are a part, is the world's largest global custody bank by safe custody assets. BNYMLB and BNYMIL are the third and eighth largest custody banks in the UK respectively and provide custody services jointly to 6,089 UK-based clients. During the period of their breaches, the safe custody asset balances held by BNYMLB and BNYMIL peaked at approximately £1.3 trillion and £236 billion respectively. As a result of this, the Firms are systemically important to the UK market.

The Custody Rules require firms to keep entity-specific records and accounts. Entity-specific records and accounts are important in the event of an insolvency as they will

be used by an Insolvency Practitioner to identify those clients whose assets are safeguarded and are due to be returned. Instead, the Firms used global platforms to manage clients' safe custody assets, which did not record with which BNY Mellon Group entity clients had contracted. This failing meant that the Firms were unable to meet their other obligations under the Custody Rules, such as the requirements to:

- Conduct entity-specific external reconciliations;
- Maintain an adequate CASS resolution pack (from 1 October 2012 when the requirement to do so came into force); and
- Submit accurate Client Money and Asset Returns (CMAR) (from October 2011 when the requirement to do so came into force).

The FCA also found a number of other failings by the Firms including:

- Failing to take the necessary steps to prevent the co-mingling of safe custody assets with firm assets from 13 proprietary accounts;
- On occasion using safe custody assets held in omnibus accounts to settle other clients' transactions without the express prior consent of all clients whose assets were held in those accounts; and
- Failing to implement CASS-specific governance arrangements that were sufficient given the nature of the Firms' business and their failure to identify and remedy the failings identified.

These failings reflected a failure by the Firms to consider properly the interests of their clients. The Firms' failings occurred between 1 November 2007 and 12 August 2013. The FCA's specialist client assets supervisors identified most of the failings as part of their regular review of such firms. The Firms agreed to settle at an early stage of the FCA's investigation and therefore qualified for a 30% (stage 1) discount. Were it not for this discount, the financial penalty would have been £180 million."

AMENDMENT TO FCA CLIENT ASSETS REGIME: Return to contents

As a reminder of a three-phased amendment, the FCA has implemented Policy Statement PS 14 / 9 ~ Review of the Client Assets Regime for Investment Businesses.

It is highlighted within PS 14 / 9 that the rules are designed to ensure that investment firms better protect client money and custody assets (together '**client assets**') while responsible for them. Additionally, it is highlighted that consumers will receive enhanced information about how firms hold their money and assets, and the protections available to them under CASS.

PS 14 / 9 (which sets out the extensive amendments to CASS) summarises the changes, and their effective dates being as follows:

- "**1 July 2014** – certain rules and guidance come into force providing clarifications to existing requirements, introducing optional arrangements with which firms may choose to comply and limiting the placement of client money

in new unbreakable term deposits. These include clarifications of application provisions and the introduction of the option to operate multiple client money pools;

- **1 December 2014** – certain rules and guidance come into force relating to the provision of information to or obtaining the agreement of new clients and the documenting of agreements and arrangements with any new counterparties with whom firms deposit or otherwise place custody assets or client money, these include requirements to notify the client of certain matters if operating the banking exemption and mandating the use of template acknowledgment letters with new client bank accounts and client transaction accounts; and

- **1 June 2015** – all of the remaining rules and guidance come into force and firms will need to ensure they fully comply with all of the new rules set out in this PS."

There was minimal impact on the conduct of a reasonable / limited assurance assignment in respect of the amendments which came into force on 1 July / 1 December 2014. The HAT FCA Client Assets Reports Manual was updated in March 2015 to reflect the requirements for CASS debt management firms, and fully reflects all of the new requirements for a reasonable / limited assurance assignment which arise from the implementation of PS 14 / 9.

INSURANCE INTERMEDIARIES: Return to contents

It is some time since the FCA consulted on amendments to CASS 5 (indeed this happened in 2012).

The latest Policy Development Update from the FCA indicates that the next stage in the process (to publish CASS 5A), which was, in the November 2014 Policy Development Update being shown as happening in Q1 / 2015, is now being shown as "TBC". It is therefore unclear when / whether these changes will be made.

PROPERTY AGENTS' CLIENT MONEY UPDATE: Return to contents

Update to Client Money Rules:

The National Federation of Property Professionals ("NFoPP") updated their Conduct and Membership Rules with effect from 1 January 2016. The revised document can be obtained on their website.

The changes from the previous version are largely cosmetic. The main changes highlighted by NFoPP are that a specific time limit (three working days) has been imposed on transferring non-client money out of the client account and that further guidance has been provided on Client Accounting Service Providers (CASPs). This is where a property agent does not hold the client money themselves, but instead a third party (the CASP) holds the funds. Although the rules have not changed significantly it is worth highlighting the key points.

If the CASP is an NFoPP member firm or RICS regulated and the following apply:

- All Client Monies are paid direct to the Client Account(s) owned by the CASP;
- All terms of business, landlord and tenancy agreements clearly identify the legal names of the Principal Agents;
- All terms of business, landlord and tenancy agreements must clearly identify the legal name of the CASP in all references to Client Money;
- The CASP is the only firm to be able to make payments/withdrawals from the Client Account(s);
- The CASP provides NFoPP with a standard annual accountant's report for ALL the Client Money it handles; and
- Both Principal and Agents pay the NFoPP levy.

Then the individual agents do not hold client money and no separate accountant's report for them is required. However, if all of the above does not apply, the property agent using the CASP must arrange for a client money report on their client funds held by the CASP to be completed and submitted. In practice, the accountant may be engaged by either the agent or the CASP but it is the agent's responsibility to ensure that the report is completed.

Fines to be imposed for late reports:

Members of ARLA, NAEA, ICBA and NAVA who are responsible for regulated firms will face automatic fines of up to £200 for late submission of accountant's reports.

This measure is being implemented for accountant's reports with a year end of 31 August 2015 and later. These reports are due with NFoPP Regulation by 29 February 2016. From this date onwards, all accountants' reports not submitted within the six month deadline will be subject to these fines.

The fines are being implemented to encourage members to provide documents on time. This has been necessary as a result of a relatively small number of firms which take up a disproportionate amount of staff resources (and therefore membership fees) when they fail to provide their documents on time.

The facility to introduce fines for late submission of regulation documents has been in place since the NFoPP Sanctions Policy was introduced in May 2012, but for administrative reasons this has not up to now been implemented. Notice of this ability has been included in reminders for documents since that time, and there is also information displayed on the NFoPP Regulation website. For the time being the facility is only being implemented for accountant's reports.

Status of Client Accounts:

It has been identified by NFoPP that apparently some banks are changing client account status without checking first! This will therefore lead to an automatic breach of sections 1.7.1 and 1.7.2 of the accounting rules within the NFoPP Conduct and Membership Rules.

Although it has not been specifically highlighted as an issue by other bodies that regulate entities which hold client money, it is sensible to be aware when undertaking any client money assignment that banks are, in certain cases, unilaterally changing the status of client accounts.

HAT COURSE DATES: Return to contents

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

- SRA Update – Ensuring you Get the Correct Qualification ~ Tuesday 9 February 2016; and

- Introduction to SRA Accounts Rules 2011 Assignments ~ Wednesday 9 March 2016.

These CPD courses will be running in Central London, or may alternatively be run, "in-house" at firm's offices on a mutually convenient date during 2016.

Additionally, it is possible for CPD courses relating to Service Charges, Property Agents' Client Money, and Insurance Brokers' Client Money to be provided, subject to demand.

For details of our charges and availability, please contact Roger Morris at the HAT Office at roger@hatgroup.co.uk.

HAT ASSURANCE MANUALS: Return to contents

HAT SRA Accounts Rules 2011 Manual:

The current HAT SRA Accounts Rules 2011 Manual is dated November 2015, and it reflects the current version (Version 15) of the SRA Accounts Rules 2011. Details of amendments reflected in Version 15 have been noted above.

HAT FCA Client Assets Reports Manual:

The HAT FCA Client Assets Reports Manual is dated March 2015, and was updated to reflect the requirements for the conduct of a reasonable / limited assurance assignment for CASS debt management firms, and also all of the new requirements which arise from the implementation of PS 14 / 9 noted above.

The renaming of the Manual (from the HAT FCA Manual) more closely reflects the scope of the assignments covered by the Manual.

Additionally, the way in which the Manual is structured has also been amended to clearly distinguish between assignments where a CASS auditor is required to produce a Client Assets Report, and one where such a report is not required. All documentation relating to an "Exemption" assignment (where there is no requirement to appoint a

CASS auditor) is now included within the FCA Exemption folder within the Manual. This includes checklists to determine whether or not a CASS auditor needs to be appointed in accordance with SUP 3.1 of the FCA Handbook (which were previously included at Appendix 3 / 3-IB of the HAT FCA Manual (June 2013)).

Important Note

With regards to the technical articles in this newsletter, every care has been taken by HAT in the preparation of these articles, HAT does not guarantee the accuracy or veracity of any information or opinions. No responsibility for loss occasioned to any person acting or refraining from acting as a result of material contained within these articles can be accepted by the editor, HAT, its officers or employees.