Response to the Solicitors Regulation Authority consultation

Client money in legal services safeguarding consumers and providing redress

We thank the SRA for opening their consultation on client money in legal services for response. Whilst we are not a firm of solicitors, Kreston Reeves are a top 40 accountancy firm, and we have offices across London, Kent and Sussex, as well as global reach through our membership of Kreston Global, an international advisory and accountancy network across 115 countries. We pride ourselves on being in regular contact with our clients to discuss ongoing compliance and commercial matters, as well as proactively discussing with our clients how they can mitigate the risks to client money, before the regulator makes such changes mandatory.

We previously responded to the SRA on their consumer protection review discussion paper back in June 2024. Since the current consultation opened, we have been discussing this with our clients, as well as several intermediaries working in the legal sector, collated their views and combined these with our own thoughts and experiences, in putting together our response below. We are therefore well placed to be able to provide feedback on the recent consultation.

We appreciate that the aim of the consultation is to safeguard clients of legal firms and to provide redress, particularly in the wake of the Axiom Ince incident, where over £60m of client money was misappropriated. We have therefore considered the SRA's proposals in each of the three areas below within the context of the overall aim of consumer protection, highlighting the areas we feel are the most pertinent.

Much of our discussion below is focussed on the first part of the consultation, being the model of solicitors holding money, although there is inevitable overlap with part two of the consultation, particularly in respect of the controls that firms should have in place.

Overall, although certain prescriptive rules are not unwelcome, there should be greater focus on oversight of firms, with the SRA implementing systems and controls to reinforce the importance of robust policies and procedures with firms. We believe this to be a more effective route to safeguarding consumers, than reintroducing more prescriptive rules across all areas which could be seen as arbitrary.

Residual balances

This has been a key focus area for the SRA for some time now, with various warning notices and guidance issued. The SRA's proposal is to prescribe that excess funds must be returned within 12 weeks of the conclusion of a matter, with a potential 12-week extension available in certain circumstances, such as contact details being insufficient.

We feel that, essentially, this shouldn't cause too many practical difficulties for firms to implement. There are a number of internal processes which could be used to help firms remain compliant with the addition of this timeframe into the rules, including more robust processes for retaining and updating client contact information and bank details.

Furthermore, as part of the existing three-way reconciliation requirements, COFAs should already be monitoring slow moving balances as part of their month end processes. Software providers may also be able to help here, if they can provide updated reports showing balances that have not moved for, say 2 months.

Regularly circulating a list of matters showing no movement for a defined period to fee earners for clarification on why funds remain to be held is crucial for keeping on top of residual balances. In many cases there may be legitimate reasons for balances to continue to be held, such as waiting for the Land Registry, or waiting for probate to be granted etc. However, in cases where there is no legitimate reason to continue to hold funds, it is critical that efforts are made to made to return funds as soon as possible. Without these processes, therefore, residual balances can accumulate and become more difficult to clear.

Interest

We understand that the SRA are proposing to eradicate the ability of law firms to earn interest on client funds, in order to prevent the incentive for firms to hold on to client money for longer than necessary.

We understand there is a split of opinion here, some argue that this could put smaller firms under financial pressures by removing a source of income which can help firms to cover their administrative costs. If the ability to earn interest from client funds is removed, firms could end up increasing hourly rates, or in severe cases, fail completely. However, many firms we have spoken to confirm that they currently treat interest income as a bonus and are not reliant on that source of income for future trading.

It has already been identified that client monies may be at greater risk where they are held by firms that are under financial pressure. However, we recognise that the ability to earn interest from client funds can, in some cases, create incentives to hold on to client money for longer than necessary. This can in turn lead to issues with residual balances.

There are also links to breaches of the banking facilities rule here, which is another key area for the SRA. It is felt that it is wrong for clients to benefit from an investment perspective from funds being held in a client account. Therefore, if firms are considered to be ‘too generous’ to clients under the existing guidelines, it could be seen as providing banking facilities.

As a result, some firms pull together interest matrixes in order to determine the rate of interest that should be paid over to clients, which are updated regularly. The SRA could produce such matrixes which detail the ‘fair’ rate of interest that all firms should adopt, so long as this does not result in firms having to pay interest in excess of the rate received. This would avoid the current ambiguity as to what constitutes a fair rate and foster a consistent approach across the legal sector.

If firms are unable to retain interest, it is likely to negatively impact both solicitor firms and banks. It also does not necessarily follow that clients would benefit. In these circumstances, firms are unlikely to negotiate higher rates of interest for client deposit accounts, which is not benefitting the client. However, we would highlight

that this stance is based on our own experiences, and that if the issue of firms holding onto funds for too long is widespread, then an argument could be made that clients could benefit from changes to the rules here. In our experience, in the rare circumstances that we come across such an issue, these cases tend to result from poor systems and controls leading to delays and poor client care, rather than from the intention to accumulate interest.

Whilst the interest calculation does not currently fall within the scope of the SRA Accounts Rules, many reporting accountants conduct a small amount of testing, to ensure that the firm's internal interest policies are applied correctly. The SRA could consider pulling interest into the scope of the rules, so that it can be more consistently tested to ensure that clients are not losing out. The SRA should therefore provide clarity surrounding what constitutes a fair rate of interest, as well as considering the possibility of providing interest matrixes for firms, as outlined above.

Advance fees

The consultation refers to the potential for more prescriptive terms surrounding when a firm is able to request advance fees and the amount they are able to request. Many of our clients were concerned about this proposal.

In the case of litigation, for example, counsel fees can be significant. Without the ability to request monies on account of such costs, legal firms could be exposed to great financial risk, and cash flow difficulties. One could argue that this could pose an increased risk to client funds.

We understand that the consultation refers to the fact that it may be reasonable for firms to request fees in advance that cover all the anticipated costs and disbursements, but not for a matter expected to last longer. Some of our clients felt that if the ability to ask for costs up front were to be subject to an arbitrary maximum level, that they would not be able to move as quickly as possible in the best interests of their clients. They were also conscious of the fact that some matters can take a long time to reach a final conclusion/completion, but that the legal work (and therefore costs) can move quickly, and solicitor firms need to have funds on hand to be able to serve their clients' needs.

We feel that as long as the firm can justify the costs and disbursements being requested up front, that introducing an arbitrary maximum would penalise some areas of legal work more than others, as well as potentially reducing the quality of legal services provided to clients. This could also lead to increases in charge out rates, as firms try to limit their risk exposure. These potential consequences would not benefit the end consumer.

Firms should have policies in place, as well as possibly disclosing advanced fees within their terms and conditions. Evidence to justify advance fees should be available, if the SRA were to request, that the SRA accounts rules and the firms' terms and conditions have been adhered to. However, we acknowledge that it is difficult to be prescriptive in all areas of law.

Alternatives for holding client money

The consultation covers both short- and longer-term goals of the SRA. The proposal of the SRA is to move towards Third Party Managed Accounts (TPMAs) in the longer term.

Our clients felt that this move, even in the longer term, was an extreme measure. They were particularly concerned that a move to TPMAs could lead to errors, poor service, and the possibility of delays to completing on transactions. Many argue that the use of TPMAs could represent the shifting of risk, rather than a reduction of risk.

Our clients raised a number of specific concerns here. The move to the use of TPMAs would represent a bigger pool of money being held, and looked after by, a smaller number of people. This in itself poses additional risks such as that of cybercrime and also begs the question of what would happen in the case of failure of a TPMA, and whether client funds would be protected. Our clients were therefore concerned about the regulation of TPMAs.

Furthermore, the use of TPMAs could generate increased administrative burdens and create increased costs for both firms and consumers. There is likely to be some duplication of due diligence and AML processes, as solicitor practices and TPMAs remain compliant. Many TPMAs also charge by the transaction and the charges for their services can be significant. Firms may need to increase their charge out rates to cover their increased costs, which could reduce the accessibility and affordability of legal services for consumers.

Our view is that more evidence is needed on how the use of TPMAs has worked in other jurisdictions before any further steps could be taken here. A thorough assessment of the availability and accessibility of TPMA services to solicitor firms of all sizes is required. We think that any move to TPMAs at the current time would be premature, especially considering that according to the SRA's own survey of over 2000 consumers, 79% were comfortable with regulated solicitors holding their money. Similarly, the Legal Services Consumer Panel Tracker Survey 2024 found that 77% of consumers trusted solicitor firms with their money.

Improving oversight

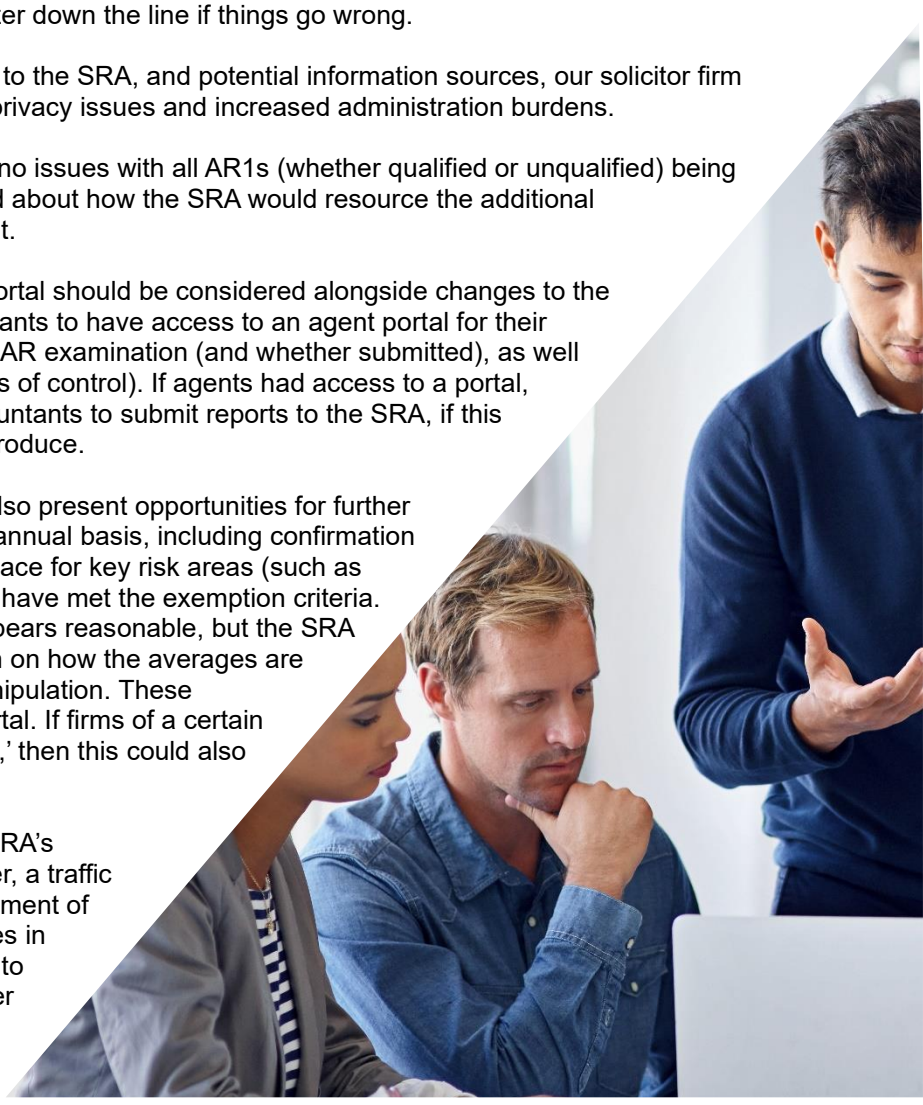
The general consensus is that greater oversight of firms is required. There are a number of proposals on how to achieve this, including the possibility of increased requirements for notifications to be made to the SRA, as well as additional requirements regarding mergers and acquisitions. At present, the SRA are only engaged to the extent that they must be notified of a change in control, meaning there is plenty of scope for additional steps to be taken. A more hands-on approach may be more appropriate, given that mergers and acquisitions can sometimes involve failing firms.

We raised in our previous response to the SRA's discussion paper, that such an approach would be more in line with other regulators such as the FCA and could help to mitigate the risks to client funds from the structural/ procedural changes associated with mergers and acquisitions. Having oversight at this stage could be a lot less expensive than interventions later down the line if things go wrong.

However, in respect of information provision to the SRA, and potential information sources, our solicitor firm clients were predominantly concerned with privacy issues and increased administration burdens.

Whilst in principle, our clients generally had no issues with all AR1s (whether qualified or unqualified) being submitted to the SRA, questions were raised about how the SRA would resource the additional administration arising on their end as a result.

We feel that some changes to the MySRA portal should be considered alongside changes to the AR1. It could be useful for reporting accountants to have access to an agent portal for their clients, which could show the status of the SAR examination (and whether submitted), as well as recent filings (e.g. notifications of changes of control). If agents had access to a portal, then this would also allow for reporting accountants to submit reports to the SRA, if this were deemed an appropriate measure to introduce.



The MySRA portal and accountants report also present opportunities for further declarations to be made by law firms on an annual basis, including confirmation that written policies and procedures are in place for key risk areas (such as residual balances), as well as whether firms have met the exemption criteria. We feel that the current de-minimis level appears reasonable, but the SRA could consider a more prescriptive approach on how the averages are calculated to reduce any opportunity for manipulation. These averages could then be disclosed on the portal. If firms of a certain size were required to have a 'risk committee,' then this could also be confirmed as part of the MySRA portal.

As mentioned in our initial response to the SRA's consumer protection review discussion paper, a traffic light system could be used based on assessment of risk. For instance, if there have been changes in control or structure, or firms are just starting to hold client money, this could indicate a higher level of risk, and therefore firms could be required to provide more information on the MySRA portal or accountants report.

The proposed rotation of reporting accountants is, in our opinion, extreme especially given the current requirements for statutory audits. Reporting accountants should have their own internal policies ensuring independence and appropriate oversight to comply with their code of ethics. If reporting accountants were required to rotate, then there will be increased costs associated with accountants needing to familiarise themselves with firms' systems. The MySRA portal could be used to track the reporting accountant of each firm, meaning that the SRA would be better informed.

We agree in principle that there is no issue with the SRA being in receipt of all AR1s, provided there are no increased administrative burdens placed on the reporting accountants in this regard. The SRA would be better placed to consider the implications of repeated qualified AR1s, for instance, it may or may not be appropriate to publish whether reports are qualified to provide increased transparency to the end user.

COFA/ COLP functions

We agree with the SRA's proposals to build support packages for compliance officers, to aid them in their duties and to help improve their effectiveness and impact.

Many of our clients also felt that there should be training and certification requirements for ongoing professional development of COFAs.

We feel that there should be compulsory training courses, with ongoing CPD being logged with the SRA. There is also potential to consider the need for qualifications as a longer-term plan.

Conclusion

A considerable number of changes have been proposed by the SRA, both in the short term and longer term. Many of our clients felt that some of these changes seemed premature and reactionary in the wake of Axiom Ince.

We believe that there should be increased focus on the systems and procedures both within solicitor firms, and the SRA. We feel this is likely to be more effective than arbitrary changes which may not suit all types of law equally.

If the majority of firms are compliant with the current SRA accounts rules, then a number of the proposed changes, to make the rules more prescriptive, may not lead to any benefit to the end consumer. More prescriptive rules are only likely to be beneficial where firms are non-compliant and are not acting within the best interests of their clients.

It is therefore important to focus on the minority of non-compliant solicitor firms, rather than implementing widespread changes for all. Improved oversight from the SRA would help to deal with these issues by holding firms, specifically COFAs, responsible and accountable.
There do remain, however, some areas where we, and our clients, would welcome a more prescriptive approach and/ or increased clarity to remove ambiguity for both clients and the reporting accountants, such as residual balances.

We would also suggest that changes to the AR1 form and MySRA portal could be implemented relatively easily and would be effective at highlighting issues requiring further attention from the SRA to focus the efforts of limited resources towards non-compliant firms.

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