In contravention of legislation ... ?

By the financial forensic unit of the Attorneys Fidelity Fund

Section 78(2A) of the Attorneys Act 53 of 1979 and s 86(4) of the Legal Practice Act 28 of 2014 (LPA) allow attorneys to invest client monies in a separate trust savings account or other interest-bearing account where there is an underlying transaction with an explicit mandate from the client to do so. For purposes of this article, we will refer to such investments as investments in terms of the Act.

Attorneys from time to time open investment accounts in terms of the Act for their clients where the underlying transaction takes longer to complete. These investments remain part of entrusted monies and are recorded in the general trust accounting records of the attorney's practice and enjoy protection by the Attorneys Fidelity Fund (the Fund).

With effect from 1 March 2016, the attorneys are regulated in terms of the Rules for the Attorneys Profession (GenN 2 GG39740/26-02-2016) (the rules). The rules permit attorneys to invest on behalf of individuals without there being an underlying transaction. Monies invested in terms of the rules have no underlying transactions and are not earmarked for any purpose except to invest, do not form part of the general trust monies and should not be accounted for as part of the general trust monies/balances, and do not enjoy the protection of the Fund. The question that arises is whether monies invested in terms of the Act are always correctly classified as such.

This article seeks to explore the various instances where attorneys may incorrectly invest client monies in terms of the Act, whereas the money should have been invested in terms of the rules and the implications thereof. The rules state as follows:

'Rule 36.1 A firm shall for the purpose of this rule be deemed to be carrying on the business of an investment practice if it invests funds on behalf of a client or clients and it controls or manages, whether directly or indirectly, such investments.

Rule 36.2 A client shall for the purposes of this rule include any person on whose behalf a firm invests funds or manages or controls investments, whether or not such person is otherwise a client of the firm concerned. …

Rule 36.4 A firm carrying on an investment practice shall obtain an investment mandate from each client before or as soon as possible after investing funds for that client. The form of the investment mandate shall be substantially in the form of the Fifth Schedule to these rules, and shall contain a statement that the client acknowledges that moneys so invested do not enjoy the protection of the Fund.'

Readers are urged to read r 36 in full to get more information on Investment Practice Rules.

The Financial Services Board (FSB)

The FSB is a unique independent institution established by statute to oversee primarily the South African non-banking financial services industry in the public interest. The FSB supervises financial advisory and intermediary activities in the financial services sector through its Financial Advisory and Intermediary Services (FAIS) department in terms of the Financial Advisory and Intermediary Services Act 37 of 2002 (the FAIS Act). The FAIS Act was designed to protect consumers of financial products and services. It applies to any provider of financial services and its representatives, as well as any person who gives financial advice or who provides an intermediary service.

Section 7(1) of the FAIS Act states that: '… a person may not act or offer to act as a –

(a) financial services provider, unless such person has been issued with a licence under section 8'.

Section 19(3) of the FAIS Act states that: 'The authorised financial services provider must maintain records in accordance with subsection (1)(a) in respect of money and assets held on behalf of clients, and must, in addition to and simultaneously with the financial statements referred to in subsection (2), submit to the registrar a report, by the auditor who performed the audit, which confirms, in the form and manner determined by the registrar by notice on the official web site for different categories of financial services providers –

(a) the amount of money and financial products at year end held by the provider on behalf of clients;
(b) that such money and financial products were throughout the financial year kept separate from those of the business of the authorised financial services provider, and report any instance of non-compliance identified in the course of the audit and the extent thereof; and
(c) any other information required by the registrar.'

Section 36 of the FAIS Act states that: 'Any person who –

(a) contravenes or fails to comply with a provision of section 7(1) or (3), 8(8), 8(10)(a), 13(1) or (2), 14(1), 17(4), 18, 19(2), 19(4) or 34(4) or (6);
(b) in any application in terms of this Act, deliberately makes a misleading, false or deceptive statement, or conceals any material fact, … is guilty of an offence and is on conviction liable to a fine not exceeding R 10 million or imprisonment for a period not exceeding 10 years, or both such fine and such imprisonment.'

Readers are urged to read in detail ss 8, 13, 14, 17, 18, 19 and 34 of the FAIS Act.

On 28 November 2012 the FSB issued 'Circular on Financial Services Provides who operate Cash Management System Accounts' (FAIS Circular 11/2012, 28-11-2012) (www.fsb.co.za, accessed 3-3-2016) dealing with Financial Services Provider's (FSP) who operate Cash Management System Accounts (CMS Accounts). The Circular was aimed at clarifying to the industry whether a s 19(3) audit report is required from FSPs who operate a CMS account or not. This came as a result of a growing number of FSPs rendering financial services on the CMS bank account currently offered predominantly by Investec Bank – Corporate Cash Management Account (CCM) and Nedbank – Corporate Saver System Account (CSS). Attorneys were identified to be among the types of businesses that banks currently offer the systems to.

Following the circular, the Fund's Board of Control obtained a legal opinion, which effectively advised that attorneys making use of these systems should be licensed as FSPs. Following the sought opinion, on 3 March 2015 the Law Society of South Africa (LSSA) wrote to the Senior Legal Adviser of the FSB requiring clarity on the Circular and expressing the views of the LSSA on the various investments that attorneys are involved with, being the investments in terms of the Act and the investments in terms of the rules. The views expressed by the LSSA were that the investments made in terms of the Act are incidental to the attorney's practice and that attorneys need not be FAIS compliant on these investments, whereas investments made in terms of the rules should require compliance with FAIS.

The Deputy Registrar of the FSB, in a response dated 23 July 2015, concurred with the LSSA that investments in terms of the Act would not fall within the ambit of the FAIS Act, while investments in terms of the rules would require compliance with the FAIS Act.

We will now consider various scenarios where an investment is considered an investment in terms of the rules and not an investment in terms of the Act and where attorneys are subjected to the FAIS Act:

• Scenario 1

A client (including the employees of the attorney firm and its directors or partners) approaches an attorney and asks that the attorney invests money on his or her behalf without there being any underlying transaction. The money is therefore not earmarked for any transaction except to invest.

This is a pure investment made in terms of the rules with interest accruing to the owner of the Funds. It is not covered by the Fund and does not form part of the general trust accounting of the firm. The attorney is required to be licensed as an FSP and to be FAIS compliant.

• Scenario 2

A client of a firm approached an attorney on a litigation matter, the litigation matter is, therefore, the underlying transaction. The client pays money into the trust account of the firm pending completion of the underlying transaction. This money is invested by the attorney in terms of the Act, while the litigation continues, gets reported as part of the general trust and enjoys protection by the Fund. The underlying transaction is then finalised and the attorney is released from the mandate. However, after the attorney has made all the required payments in terms of the underlying transaction and has taken fees for the services rendered, there is still money remaining, which is a client refund. The client opts for a non-refund and instructs the attorney to continue keeping the funds in the investment until the client instructs the attorney to refund him or her.

From the point where the underlying transaction is completed the invested funds have changed form and can no longer be invested in terms of the Act but need to be withdrawn from the initial investment account and invested in terms of the rules. From this point onwards, the investment no longer enjoys the protection of the Fund, should no longer be reported as part of the general trust balances and the attorney should be FAIS compliant.

• Scenario 3

A client of a firm approached an attorney on a litigation matter, the litigation matter is, therefore, the underlying transaction. The client pays money into the trust account of the firm pending completion of the underlying transaction. This money is invested by the attorney in terms of the Act while the litigation continues, gets reported as part of the general trust and enjoys protection by the Fund. The underlying transaction is then finalised and the attorney is released from the mandate. However, after the attorney has made all the required payments in terms of the client mandate and has taken fees for the services rendered, there is money still remaining, which is due to be refunded to the client. The client opts for a nonrefund and instructs the attorney to keep the money in an investment pending a future underlying transaction.

Where the attorney expects to provide a future legal service to the client, until such time as there is in fact an underlying transaction, the investment no longer enjoys the protection of the Fund, should no longer be reported as part of the general trust balances and the attorney should be FAIS compliant. On receipt of an explicit mandate for an underlying transaction by the attorney, the money can again be invested in terms of the Act.

From the above scenarios, it is important to note that money can change form over the period that it is in the hands of the attorney, and these are considered when a complaint or claim arises on invested funds. Attorneys should ensure that the form of the money is accurately determined for investment purposes at all times.

Levy on investments

Section 86(5)(b) of the LPA requires that interest accrued on money deposited in terms of s 86(4) must be paid over to the owner of the funds provided that 5% of the interest accrued on those funds must be paid over to the Fund and vests in the Fund. It therefore follows that, if invested money is incorrectly invested as an investment in terms of the Act, the Fund will incorrectly levy a 5% on the interest accrued, while the investment in itself enjoys no protection from the Fund.

Conclusion

It is clear from the foregoing paragraphs that proper and accurate distinction of investments should be made by attorneys to ensure compliance with relevant legislation and/or regulations. In summary, the following critical points should be ensured by attorneys who run investment practices as they must –

- be licenced to do so by the FSB;
- obtain a mandate from the client to invest his or her money;
- make an accurate classification of an investment at all times;
- explicitly disclose to the client that the investment is not protected by the Fund; and
- fully comply with the requirements of the FAIS Act.

Failure to comply with the requirements of the FAIS Act by attorney firms running investment practices may result in penalties, which include a monetary fine and/or imprisonment.

Remember, if you invest in terms of the Act without an existing underlying transaction, you are contravening legislation.