TaylorWessing

For the attention of Mr Paul Smith

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Date
9 December 2015

Our reference
SVF/AVH

Your reference

Dear Sir

Consultation on the technical legislative implementation of the EU Audit Directive and Regulation ("the Consultation")

We welcome the opportunity to respond to the Consultation and to comment on the proposed draft of The Statutory Auditors and Third Country Auditors Regulations 2016 (the "draft Regulations").

Taylor Wessing LLP is an international law firm with a specialism (amongst other things) in acting for the accountancy profession in relation to litigation and regulatory issues. Our team's experience includes acting on a significant number of regulatory investigations and civil proceedings including those relating to the audits of *BCCI, Barings, Equitable Life, Mayflower* and several ongoing matters with the Financial Reporting Council ("FRC").

Our comments below are limited to the changes proposed to the FRC's powers which concern the exercise of its disciplinary jurisdiction.

Overview comments

1. In general terms, we agree that it is sensible for there to be one competent authority dealing with investigations and disciplinary cases relating to the statutory audit of Public Interest Entities ("PIE"s). Under present arrangements, there is the potential for either the FRC or a Recognised Supervisory Body ("RSB"), such as the ICAEW, to have competing claims on the investigation of a particular matter. That does not seem to us helpful, not least where the applicable thresholds for sanction by the RSBs and FRC are different.

2. We also agree with the proposals in the draft Regulations for the FRC to have powers to obtain information and documents from third parties connected with the audit process. The absence of such powers (on a statutory footing) has, in our experience, caused practical difficulties in the conduct of investigations to date.

3. We do not consider it is clear from the Consultation as to how the disciplinary regime envisaged by the draft Regulations will dovetail with the FRC's existing Accountancy Scheme (the "Scheme") and consider it important that this be clarified.

4. On its face, the current version of the draft Regulations provides for a new disciplinary regime in relation to which the FRC would have jurisdiction to sanction auditors for any contravention of a "relevant requirement", namely a requirement of the Regulations, a requirement of the Audit Regulation or a requirement of Parts 16 or 42 of the Companies Act 2006. It is not clear whether the FRC would need to establish, as it presently must in the case of Misconduct under the Scheme, that the conduct in question has also fallen "significantly short" of the standards to be expected.

5. It seems to us critical that this is made clear. If, as it would appear, this is proposed to be a separate disciplinary regime under the auspices of the FRC, there seems to us a substantial risk of unfairness in running two parallel processes.

6. In particular:

   (a) the requisite tests for sanction may be different whether the disciplinary process is conducted under the Scheme or pursuant to the draft Regulations ("Misconduct" as opposed to "contravention of a relevant requirement") even though either process could equally apply in respect of the same conduct. That seems to us obviously unsatisfactory; and

   (b) it is not at all clear that the procedural safeguards set out in the Scheme would also apply to the process envisaged by the draft Regulations (as to which we comment further below). It seems to us important that appropriate safeguards, such as a hearing before an independent Tribunal to determine whether to impose sanctions should (to the extent permissible having regard to the terms of Regulation No. 537/2014), form part of any disciplinary process. Assessments as to the conduct of audit work frequently raise difficult issues: dependent upon a full understanding of an often complex factual background and highly debatable questions of judgment. Such assessments are, in our experience, very often ill-suited to any summary disciplinary procedure.

7. We note that whilst the draft Regulation sets out the FRC's powers to impose sanctions, it is silent as to the process which will be followed by the FRC in deciding whether or not a 'relevant requirement' has been contravened. Although the FRC must comply with the requirements of national law, for example the Human Rights Act 1998, when determining whether to exercise the sanctioning power, we consider that the absence of any detail in the draft Regulations as to the procedure which will be followed by the FRC when determining whether to impose a sanction is an unsatisfactory feature.

8. In circumstances where the sanctioning powers enable the FRC to prohibit an individual or a firm from carrying out audit work and these powers will take effect from June 2016 we would ask that serious consideration be given to setting out the basis on which enforcement action will be taken by the FRC. We note that Regulation 4 does not provide for an independent Tribunal to be appointed in order to determine whether to impose a sanction. We would advocate that the procedure for imposing a sanction under

Regulation 4 should (to the extent permissible having regard to the terms of Regulation No. 537/2014) follow that currently provided for in the Scheme for cases of Misconduct and that the draft Regulations provide for this in terms. Disciplinary action concerning audit work frequently requires close consideration of judgement calls made by the auditor to be undertaken. In circumstances where the individual or firm faces the prospect of a material sanction we would strongly advocate that the sanctioning decision is taken by an independent Tribunal and that there is proper opportunity for the provision of expert evidence.

9. However, if an alternative approach is to be followed, then we consider it would be appropriate that this form the subject of proper consultation and that the enforcement procedure be set out in the draft Regulations in the same way, for example, as it is prescribed for the Financial Conduct Authority in the Financial Services and Markets Act 2000. It is important that the details of the proposed arrangements are provided as soon as possible in order that they can be the subject of proper consultation.

10. In short, it seems to us important that there is one disciplinary process applied by the FRC. To the extent that this involves changes to the operation of the Scheme, then those changes should be fully explained at this stage, and there should be proper consultation in relation to them. Further, and related to the above point, we consider that the same definition of Misconduct should be applicable in the context of any disciplinary action undertaken by the RSBs to ensure that there is consistency of disciplinary approach with regard to the standards to be expected of Members and Member Firms regardless of whether disciplinary action is being undertaken by the FRC or by the RSBs.

11. Insofar as audit inspections are undertaken by the RSBs then it seems to us these also should be undertaken using a common approach with that of the FRC.

Detailed comments on the draft Regulations

Regulation 4

12. Regulation 4(1) is drafted sufficiently widely that "a person ("A")" could include, for example, a director who had provided misleading information to an auditor in breach of section 501 of the Companies Act 2006 and who would, therefore, be susceptible to sanctions under Regulation 4(1)(a) and (b). We understand from paragraph 6.21 of the Consultation that the intention is for directors to be susceptible to the FRC's sanctioning powers (in collaboration with the Secretary of State using existing powers under the Company Directors Disqualification Act 1986). We are in favour of the FRC being able to exercise sanctioning powers against directors who provide misleading information to auditors but do not consider that the FRC's sanctioning powers in this regard should be limited solely to directors.

13. We note that "a relevant requirement" includes a contravention of the draft Regulations. However, the way in which the draft Regulations are drafted means that it is rather difficult to work out what is the particular obligation or requirement imposed on a person by the draft Regulations insofar as the "Standards" set out in Schedule 1 are concerned. Many of the paragraphs in Schedule 1 simply say "Standards must ensure..." without containing an express obligation on, for example, the statutory auditor to comply with the relevant Standard. We consider that this aspect of the draft Regulations would benefit from further clarification, especially having regard to the potential for sanctions to be applied for a contravention.

14. In terms of determining the type and level of sanction, we consider it would be helpful for draft sanctioning guidance to be consulted on which we suggest should reflect the FRC's present approach to disciplinary matters under the Scheme.

Regulation 5

15. Regulation 5(3) – in contrast to Regulation 4 this does provide for the involvement of a panel (insofar as an appeal is concerned). We would suggest that the draft Regulations provide that the panel should be comprised of persons who are independent of the FRC. We would also recommend that the draft Regulations prescribe the procedure that should be applied in respect of any appeals.

16. As set out earlier in this letter, the procedure which is intended to be followed by the FRC for the purposes of exercising its sanctioning powers is presently unclear. If it is the case that a similar process to that applicable to cases of Misconduct under the Scheme will be followed, we would advocate that the procedure for appealing a sanction under Regulation 5 should follow that currently provided for in the Scheme for appeals from cases of Misconduct and that the draft Regulations provide for this in terms.

17. If, however, the FRC does not intend there to be an independent Tribunal involved at the initial stage, then we consider that there should be a right provided for in the draft Regulations whereby there can be a *de novo* hearing before an independent Tribunal in the same way that applies in the financial regulatory context where a person can challenge a decision of the Regulatory Decision Committee in the Upper Tribunal.

Regulation 6

18. The draft Regulations do not provide any mechanism for an affected person to seek to challenge the basis on which the FRC determines how to publish a sanction in accordance with Regulation 6(1). We consider that the draft Regulations need to contain a mechanism for challenge in this respect.

Schedule 2

19. Our reading of Schedule 2 is that it is intended to enable the FRC to compel the production of pre-existing documents or to require information to be provided in writing to the FRC rather than to form a basis on which the FRC could compel interviews. If our understanding is not correct then we consider this aspect would need to be clarified and would require further consultation.

20. Paragraph 1(2) - this currently refers to *"...a notice under sub-paragraph (2)..."*. We consider this should in fact be a reference to sub-paragraph (1).

21. We consider it would be preferable for the power to be narrowed so that the information to be provided relates to the statutory audit of the entity (or a related group entity) which is the subject of the FRC's monitoring or investigation rather than more broadly.

22. We are unclear what paragraph 1(2)(b) is intended to add and think that this paragraph is unnecessary.

23. Paragraph 1(3) - we note that this does not include the *"..for any purpose related to monitoring or investigating audits..."* language which is contained in paragraph 1(2). We consider the same language should also be included in paragraph 1(3).

24. Paragraph 1(4)(d) - we consider that the reference to *"...having a connection to a statutory auditor..."* is potentially ambiguous and might not be sufficient to ensure that the FRC is able to get information from, for example, a former employee of a PIE, who was producing misleading information but did not have any direct contact with the auditor. We appreciate that the wording *"related or connected to"* appears in Article 23(c)(e) of the Regulation. To the extent possible we would suggest that this sub-section is re-drafted so that it is more clearly directed at current or former employees or officers of a PIE, its subsidiary or parent.

25. Paragraph 1(5) - the reference to the notice having to specify *"the purposes"* is somewhat vague. We presume that the FRC will be required to provide more information about the purposes than that provided for in paragraph 1(1). It would be clearer if the draft Regulations addressed this.

26. Paragraph 1(6)(a) - this contains a typo.

27. Paragraph (2) - we note that this contains a mechanism for the FRC to apply to court in circumstances where there has been a failure to provide information. However, we consider that the draft Regulations should also make express provision for the subject of a notice to be able to apply to court where they consider the request is disproportionate or oppressive. In both scenarios we consider that the issue of costs should be left for the court's discretion and should not be cast in the draft Regulations on the assumption that the costs order will always be one made in favour of the FRC. We also do not consider it necessary to include the language contained within paragraph 2(3)(b) and would suggest that this should be deleted.

28. The definition of *"the court"* in paragraph 2(4) appears rather strange - there is no reference to Scotland in relation to (d) and (e). Insofar as England and Wales are concerned we consider that the High Court and not the County Court should be the appropriate court to determine issues which might arise in respect of notices.

29. Paragraph 4 - sub paragraph (1)(b) contains a typo.

30. We are concerned at the draconian nature of the powers set out in paragraph 4 and do not consider that the requirements set out in sub paragraph (3) are sufficiently rigorous. Prior to the FRC being able to enter premises we consider that the FRC should, as a pre-condition, have reasonable grounds to believe that an offence under paragraph 5 has occurred.

31. We also consider that the draft Regulations need to provide a mechanism whereby the affected party can apply to the court in order to challenge the notice.

32. Paragraph 5 – we would question why it is thought necessary to provide for a criminal sanction and note that this is not required under the EU Audit Directive and Regulation.

33. Paragraph 5(4) - we consider that this important provision concerning the privilege against self-incrimination should be a standalone provision applicable to all of the information powers provided for in Schedule 2.

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If you have any queries or require any further information or clarification in relation to the comments set out above, please do not hesitate to contact Stephen Flaherty (s.flaherty@taylorwessing.com), Andrew Howell (a.howell@taylorwessing.com) or Julian Randall (jj.randall@tyalorwessing.com).

Yours faithfully

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