Clyde & Co response to the FRC consultation on proposed reforms to the Audit Enforcement Procedure

Introduction

1. The Audit Enforcement Procedure (AEP) was introduced in June 2016. The FRC is aware of Clyde & Co's extensive experience of matters subject to investigation under the AEP involving audits by the majority of the largest audit firms, as well as proceedings under the Accountancy Scheme (including audit cases before the AEP was introduced).

2. In its current form, in which it has operated (subject to some amendments) over the last five years, one of the concerns about the text of the AEP rules has been about aspects of procedure that commonly arise but which are not covered in the AEP. Whilst policy or practice may develop such that unwritten procedures evolve as a means of addressing any omissions and supplementing the rules with further procedural tools, a lack of clarity can be undesirable, particularly if it results in audit firms with less experience of practice under the AEP being placed at a relative disadvantage. For example, there is no statement within the current AEP about the process to be followed in respect of settlement. We therefore welcome the efforts now being made by the FRC to deal with these gaps by filling in some of that missing detail.

3. We comment below on the changes proposed to the AEP in the consultation document published on 22 July 2021, and provide some other suggestions for enhancements that might be considered. Where helpful we have sought to draw comparisons between what is proposed and the regimes of other regulators.

Decision to commence an Investigation (paragraphs 6-9)

4. We suggest that where there has been no Constructive Engagement prior to a matter being referred to the Board under draft rule 5 (d), or no adequate interval (to be a minimum three month period) for the pursuit of Constructive Engagement if that process has been formally initiated, then it would be helpful to allow Respondents an opportunity to make a submission to the Board before the Board makes its decision under draft Rule 6 as to whether to direct Constructive Engagement, and therefore before the Board decides under draft Rule 8 whether to commence an investigation. This would allow the opportunity for there to be a Constructive Engagement phase, or an adequate pursuit of that phase, which has not otherwise taken place.

Application of the AEP

5. Whilst we acknowledge the 'Guidance on the opening of AEP Investigations' dated March 2021[1], the AEP does not currently set out any clarity about the scope of the application of the AEP (particularly as concerns non-PIE audits). When the AEP will apply to an investigation is determined partly by reference to SATCAR and partly by reference to Ministerial order/direction. We suggest that this should be made clear in any revised AEP rules.

Scope of an investigation (paragraphs 11-13)

6. We believe that it is desirable for the Rules to require more specificity about the information regarding the scope and focus of the investigation that should be provided to the Respondents. At present draft Rule 11 only requires in this regard that the

[1] AEP-Guidance-on-the-opening-of-AEP-Investigations-March-21.pdf (frc.org.uk)

Respondents are informed of “the scope” of the investigation. We consider it to be important that the fullest possible details of the Allegation to be investigated should be provided to the Audit Firm and RI specifying any particular Relevant Requirements that Executive Counsel considers to represent the scope of the investigation insofar as these can be identified.

7. If the scope of the investigation cannot be identified at an early stage with regard to, and confined to, particular Relevant Requirements, then Executive Counsel should seek to inform the Respondents of the matters that are - or that it is anticipated will be - the focus of the investigation. This would assist the Audit Firm and RI in trying to understand any concerns which might not always be apparent if all that is identified is the audit year under investigation. It seems to us that this might assist in promoting enhanced cooperation at the earliest stages, which would seem to be in the interests both of the FRC and also the Member Firm and RI concerned. We recognise that in recent years Executive Counsel has improved communication of these matters in practice but the importance of this question is such that it should not left to a matter of convention and should be enshrined in a Rule.

8. We recognise that Executive Counsel should be entitled to ask the Board to amend the scope of the investigation as envisaged under draft Rules 12 and 13 (and similarly should be entitled to amend the focus if the Rules were to include a requirement to state it) but we consider that it would be sensible to have a cut-off point in time for such amendments, for example at the point when an Investigation Report (or Initial Investigation Report) is served.

9. We consider that it would be helpful for the FRC to formulate and publish a policy that sets out the circumstances in which, and/or factors influencing whether, additional parties will be added to the Investigation under draft Rules 12 and 13, as opposed to becoming the subject of a separate investigation, so that there is consistency in its decisions on these points. The decision as to whether parties are added to an existing investigation, or become the subject of a separate investigation, affects the extent of information made available to all Respondents to such investigations at the investigation stage, and consistency of approach is desirable to avoid unfair disparities arising in the entitlements of Respondents to FRC investigation.

10. Investigation Notices have in the past sometimes specified more audit years than those that have subsequently become the subject of active investigation by Executive Counsel. This results in less efficient and more time-consuming activity in response by the Audit Firm in the meantime, involving broader document searches and factual enquiries than is required to respond to the actual investigative enquiries made by the FRC. This can inevitably mean that the process of responding to Executive Counsel (either to specific requests or generally in terms of the Firm’s position in respect of the investigation when there may be opportunities for early resolution) can be more drawn out and lengthier than might otherwise be possible. In addition, overly broad notices also cause unnecessary stress, confusion and distraction to members of audit teams for the extraneous years. It seems unnecessary to include additional years in investigation notices as a precautionary measure, rather than using the power to amend the scope of the investigation if a reason were to come to light to cause Executive Counsel to consider such an extension to be necessary and appropriate. Executive Counsel may wish to include a particular audit year when stating the scope of the investigation but wishes to defer or suspend any investigation into that year pending developments in its active pursuit of investigation into another year, in which case this could be addressed in a statement of the focus of the investigation. As above, it would be helpful for a policy to be formulated and published that sets out appropriate restraints on unnecessarily broad investigations.

Powers to obtain documents and information (paragraph 14)

11. In our experience, Rule 9 Notices have occasionally been served on Respondents requiring an Audit Firm to produce all documents responsive to specified keywords. This would often require documents to be included in a Respondent's production that do not actually relate to an audit, or more specifically to the audit under investigation. Such Notices may therefore exceed in that respect the authority of Executive Counsel to compel production of documentary information. There should be an acknowledgment written into any Notices requiring Evidence, and in the AEP rules, that nothing in the Notice is capable of compelling production of material that is not within the scope of the investigation.

12. The Consultation proposes that the FRC should have a new power under draft rule 14(a) to compel Respondents to "create documents which relate to the statutory audit". We welcome the proposal to the extent that it would address concerns over client confidentiality where an audit firm is asked, or offers, to create descriptive summaries or navigational guides relating to its audit work, or (where relevant) additional analysis of financial information that appears in the audit file. However, in our view greater clarity is required in relation to this power. It should not be used to impose an onerous burden on a Respondent, or an obligation that would infringe any privilege against self-incrimination or risk depriving a Respondent of the benefit of legal professional privilege over evaluative analysis of the strength of its audit work.

The Initial Investigation Report (paragraphs 16-17)

13. The Consultation Document proposals dispense with the current requirement for the Initial Investigation Report. In our view, however, the Initial Investigation Report has a positive value by allowing an opportunity for Executive Counsel to correct any misconceptions and revise the report in light of a Respondent's submissions before finalising the Investigation Report.

14. Whilst in some cases time and expense may be saved by dispensing with the need for an Initial Investigation Report, we believe that the Rules should stipulate that Initial Investigation Reports should be served in complex cases or in any case where it appears to Executive Counsel that there are factual matters of significance to the assertions made in the report as to which there may be some dispute.

The Investigation Report (paragraph 16)

15. We note the proposed requirement at draft Rule 16 stipulating that Executive Counsel should produce "the key evidence" to the Respondents with its Investigation Report. This would replace the current requirement for Executive Counsel to provide "relevant accompanying papers" with the Initial Investigation Report.

16. In our view, the proposed requirement is unclear and could usefully be clarified to avoid unnecessary disputes as to whether Executive Counsel has complied with this obligation. For example, it is unclear whether "key evidence" would have a meaning similar to "key documents" under the Disclosure Pilot Scheme that was adopted in some English courts last year, and so would include documents on which Executive Counsel has relied "expressly or otherwise" in support of its allegations (meaning that this might go further than just documents referenced in the Investigation Report) and the documents that are necessary to enable the Respondents to understand the case they have to meet. In our view, the appropriate extent of disclosure with the Investigation Report would at least include all witness interview transcripts, all

documents referred to in the Investigation Report, all other documents on which Executive Counsel relies (whether expressly or not), and any documents which either enable Respondents to understand the case they have to meet or which are relevant to a defence that a Respondent has asserted or may have. In cases where it is relevant that there appears to have been dishonesty or fraud by the audited entity, then additional documents may have to be disclosed to enable a Respondent to understand the nature and extent of the fraud, and how it was concealed.

17. We also consider that the Investigation Report should be required to include a summary of the scope and nature of documents and information (including witness interviews) requested and obtained by Executive Counsel in the course of investigation, not limited to documents disclosed with the Investigation Report. This would enable Respondents to identify additional information gathering exercises that they may wish to suggest to Executive Counsel ought to be carried out in the interests of a complete and fair investigation.

Removal of the role of the Enforcement Committee (paragraphs 19 – 27)

18. The Consultation Document proposes the removal of the Enforcement Committee, noting that it has not so far performed any function. In the current AEP Rules, at rules 19 to 27, following receipt of a Decision Notice issued by Executive Counsel, the Enforcement Committee decides whether to issue a Decision Notice, and if that Decision Notice is not accepted by the Respondent, the Enforcement Committee then refers the matter to a Tribunal.

19. In the place of this step, Executive Counsel would be able to refer the matter direct to a Tribunal if the Respondent did not accept Executive Counsel's Decision Notice. We are concerned that this removes a valuable "second pair of eyes" check at a vital stage of the process. This is particularly important because the Enforcement Committee panel includes qualified auditors who are able to bring their practical understanding and experience to bear in ensuring a consistency of approach as between different investigations. At present the Enforcement Committee can close an investigation if it concludes that a Respondent is not liable.

20. The fact that the Enforcement Committee has not been used is a function of the effectiveness of aspects of the current AEP Rules rather than their redundancy. We do not believe there to be a sound rationale for removing this step in all cases.

The Independent Reviewer (paragraphs 23-28)

21. The Draft Rules provide at rules 23 to 28 for a new role for an Independent Reviewer, who would be a lawyer appointed from the members of the Tribunal Panel available to hear AEP proceedings. Under the Draft Rules, the Independent Reviewer would not perform the same function as that currently filled by the Enforcement Committee but instead would decide whether to approve any Proposed Decision Notice issued by Executive Counsel that a Respondent has agreed.

22. We see potential difficulties arising in the fact that this approval would be given by a lawyer who is not as well-versed in the Relevant Requirements and audit practice as an auditor. We consider that it would be preferable to have a second Independent Reviewer, who would be an auditor on the Tribunal Panel, and require that these two Independent Reviewers consult with one another; their unanimous approval would then be required. Alternatively, we would suggest that the Independent Reviewer is entitled to consult with an auditor to be appointed by the Convener from members of

the Tribunal Panel, provided that the Respondents are informed of the name of the auditor and the nature of extent of issues subject to any such consultation.

23. We believe that greater clarity is required in the Draft Rules as to the role of the Independent Reviewer, such as:
    a. the documentation that must be provided to the Independent Reviewer;
    b. the entitlement of the Respondent to provide additional documentation to the Independent Reviewer;
    c. the entitlement of the Independent Reviewer to request further information or documents before issuing a decision;
    d. the criteria that the Independent Reviewer should apply when determining whether a Final Decision Notice is appropriate;
    e. the degree of specificity to be given in the statement of reasons by an Independent Reviewer who has decided not to approve a Proposed Decision Notice;
    e. the maximum timeframe within which the Independent Reviewer would perform its function.

24. Notwithstanding the above, it is not clear to us that involvement of the Independent Reviewer is a necessary step and adds an unnecessary layer of bureaucracy and delay into the process (particularly if the Independent Reviewer were to reject a Proposed Decision Notice). The Conduct Committee will have a considerable knowledge of the matter/case (having been responsible for oversight of the Investigation since the outset) and we would respectably suggest that it is both better placed and capable of giving regulatory approval to a Proposed Decision Notice.

25. Please also see our further comments below, under 'Settlement', regarding a separate aspect of the proposed role of Independent Reviewer.

<u>Entitlement to apply for additional document production by third parties or other Respondents following a referral to the Tribunal</u>

26. We believe that the Rules should provide specifically for the right of Respondents to apply to the Tribunal, once a matter has been referred to a Tribunal and a Tribunal has been duly convened, for additional document production to be made by the PIE that was the subject of audit, or by other member firms and individual members.

<u>Evidence at hearings (paragraph 49)</u>

27. We do not agree with the proposal at draft rule 49 regarding the treatment of findings and court approved statements of fact as prima facie evidence. In our view, the effect of reducing the burden of proof on Executive Counsel to this extent would stand an unacceptable risk of leading to an unjust outcome in proceedings under this particular disciplinary regime, having regard to matters such as:-

    a. the fact that the FRC is a statutory regulator with significant sanctioning powers including the power to exclude an individual from the audit profession;
    b. the standard of proof is balance of probabilities rather than beyond reasonable doubt;
    c. the AEP Rules do not contain detailed rules of evidence such as addressing hearsay evidence and relying on the evidence of witnesses who are unable to testify;
    d. the threshold for an adverse finding is low, being simply a breach of professional standards (without the need for any ingredient of negligence, let alone requiring more serious types of conduct);

e. the impact of an adverse finding is very likely career-ending for an auditor, irrespective of the severity of sanction; and
f. the reliability of findings which may be made by any court or body that falls within the scope of the proposed rule, and the potential for a court or body within the scope of the rule to arrive at a finding that is unsafe or is only one of a number of possible findings that could reasonably have been made.

28. Further, in our view the scope of the proposed deeming of findings and statements of fact as prima facie evidence is very widely drawn. It should not include findings that have been reached without adversarial proceedings in which all of the Respondents in any matters were parties. A report by an inspector under the Companies Act does not set out findings that have been the subject of such a process. Further, the proposed draft rule 49 would treat findings by foreign courts as *prima facie* evidence irrespective of the quality of those courts (including of any panel making the relevant determination), the evidential standards that apply in those courts, the independence of the judiciary from political influence, and the ranking of the jurisdiction on global indexes of fraud and corruption etc.

Joint Tribunals (paragraphs 153-160)

29. The draft Rules make provision at paragraphs 153-160 for Executive Counsel to have the discretion to cause a Joint Tribunal to be convened to hear disciplinary allegations under the AEP and under the Accountancy Scheme or the Actuarial Scheme, where:

    a. there is a common question of law or fact;

    b. some or all of the acts or omissions which form the subject matter of the different sets of allegations arise wholly or in part out of the same event or events or circumstances; or

    c. there is a compelling reason in the opinion of Executive Counsel why the allegations should be heard jointly.

30. We recognise the value of a mechanism to enable Joint Tribunals to be appointed to hear allegations arising under different FRC enforcement regimes. However, in our view it is not a fair process for this to be possible only at the instigation of Executive Counsel, given that Executive Counsel is performing a prosecutorial role that not only requires no account to be taken by Executive Counsel of the interests of the Respondents but is adverse to their interests. In the interests of balance, and to avoid procedural unfairness, specific provision should be included for Respondents to apply for a Joint Tribunal to hear matters against them and Respondents to proceedings under other FRC disciplinary schemes, or for an AEP Tribunal to make an order for a Joint Tribunal of its own volition.

31. We also believe that guidance and/or policies ought to be issued stipulating that Executive Counsel must have regard to the potential for investigations under separate FRC enforcement regimes to be subject to a Joint Tribunal if matters were to be referred to the relevant Tribunals in all cases.

32. In our view there would also need to be provision in the Rules to address the question that arises in adapting the model of a three person Tribunal that includes a professional member (e.g. an auditor or an actuary, depending on the disciplinary regime) for a Joint Tribunal, so that for example with a Joint Tribunal hearing enforcement cases under the AEP and under the Actuarial Scheme, there may be two or more professional members of a Joint Tribunal whose role in each case would be

confined to the complaint against the member of their profession, and would not extend to the complaint against the member(s) of the other profession(s) that is the subject of the Joint Tribunal.

Confidentiality (paragraph 159)

33. We suggest that draft Rule 159 should be clarified so that it is apparent whether confidentiality attaches to correspondence between Executive Counsel or the Tribunal and Respondents in the course of investigations and procedures under the AEP or other recipients of correspondence from the FRC in the course of those investigations.

34. This would assist Member Firms in dealing with enquiries from the audit client, and in the context of disclosure in civil proceedings of such material, as it will provide a direct reference point for the explanation that information is confidential.

Settlement (paragraphs 100-109)

35. The inclusion of settlement provisions within the text of the AEP is welcome. We have three observations with regard to settlement:

Role of the Independent Reviewer

36. At paragraph 105, it is proposed that the Proposed Settlement Notice having been agreed between Executive Counsel and the Respondent(s) should be provided to the Independent Reviewer who *"shall determine whether it is appropriate to issue the Proposed Settlement Decision Notice as a Final Settlement Decision."* Our observations are that:

    a. What is meant by "*determine whether it is appropriate*" is unclear. For instance, does this mean (i) whether the outcome is fair and reasonable; or (ii) protects the public interest; or (iii) both. This should be clarified in order that the Independent Reviewer is clear on the test to be applied.

    b. As we have commented on at paragraphs [17-19] above, where there is consideration to be given to breaches of Relevant Requirements it seems to us that it is preferable for there to be consideration by, or consideration or consultation with, an auditor as opposed to a lawyer alone (and we repeat our proposals at paragraph 18 above).

    c. We consider that should the Independent Reviewer decline to approve a Proposed Settlement Notice, then it is important that he/she set out detailed reasons to allow the Executive Counsel and the Respondent(s) to understand the basis for such a rejection.

37. Notwithstanding the above, it is not clear to us that involvement of the Independent Reviewer in settlement is a necessary step and may add an unnecessary layer of bureaucracy and delay into the process (particularly if the Independent Reviewer were to reject a Proposed Settlement Notice resulting in further lengthy back and forth negotiations and proposals). The Conduct Committee will have a considerable knowledge of the matter/case (having been responsible for oversight of the Investigation since the outset) and we would respectably suggest that it is both better placed and capable of giving regulatory approval to a settlement.

Mediation

38. Other regulators use forms of ADR, such as mediation, in order to resolve all or part of a set of regulatory proceedings. For example, the FCA Enforcement Manual endorses mediation. EG/5.6.1 states:

"*The FCA is committed to mediating appropriate cases; mediation and the involvement of a neutral mediator may help the FCA to reach an agreement with the person subject to enforcement action in circumstances where settlement might not otherwise be achieved or may not be achieved so efficiently and effectively.*"

39. Guidance[2] published by the FCA on 22 April 2016 (updated 12 Aril 2017) states (emphasis added):

"*Mediation is a type of alternative dispute resolution we may use in appropriate cases to help settle disputes in a quick and cost-effective way.*

…

The mediator will not offer an evaluation of each party's case, but will purely help with the negotiations. Mediation can, in appropriate cases, supplement informal settlement discussions and provide a way of progressing a case where the discussions are unlikely to lead to an agreed settlement.

Mediation can be used in many types of cases, but ***its role is limited in regulating financial services. It will usually only be appropriate in cases where settlement may not otherwise be achieved, or not achieved efficiently and effectively****.*

Mediation is unlikely to be suitable in some types of case, for example those involving allegations of criminal conduct or where we have to take urgent action.

…

There will ***usually be only one opportunity to mediate during the enforcement process****.*"

40. Our understanding is that since mediation was introduced by the FCA into enforcement proceedings, it has worked effectively where used and it would appear to us that mediation or a mediation-type approach could play a useful role in complex regulatory proceedings. We do not suggest that mediation has a role in every matter but particularly in cases where parties' positions are providing intractable, for example where there are numerous Respondents with divergent or semi-divergent interests, it may assist them to have a third-party involved who can stand back and offer an impartial view on the merits of their respective positions, and thus get them to a place where a settlement can be agreed.

[2] https://www.fca.org.uk/about/enforcement/settlement-mediation-enforcement-cases

Early disclosure of expert reports/meetings of experts

41. We recognise that in recent years the FRC has been willing to disclose on a without prejudice basis expert advice that it has received in relation to breaches of Relevant Requirements. We consider that this approach is likely to assist the parties in reaching a settlement where experts for both parties are able to meet and to discuss their opinions. Whilst we do not think it is necessary to make this a compulsory step, we do think it would be helpful to reflect within the AEP or guidance that the parties should as part of any settlement dialogue be prepared to agree to a meeting and discussion by experts.

Appeal (Part 7)

42. We do not have any comments on the changes proposed by the FRC to the appeal tribunal process but we do have a more fundamental concern at the absence of a wholly independent check and balance on the regulatory regime governing accountants and what we have detected in recent years as a growing perception that the regulatory regime lacks such a check and balance. We believe that it is important the profession has confidence in its regulatory regime and we consider that granting accountants the same right of appeal as other professionals enjoy to a body outwith the regulatory regime is critical.

43. Under current framework and proposals, it appears that the only route to challenge a decision of FRC (outwith the framework of FRC) would lie by way of judicial review. The inordinate delays and cost in achieving access to judicial review, and the high threshold test to achieve it, mean that it is a disproportionate, and therefore ultimately unrealistic route by which to test the lawfulness of significant and potentially far-reaching decisions of a regulatory body. Decisions of the Financial Conduct Authority, the Prudential Regulation Authority and the Pensions Regulator can be referred to the Upper Tribunal (Tax and Chancery Chamber) and if permission is given, decisions of the Tribunal can then be appealed to the Court of Appeal and ultimately the Supreme Court.

44. Similarly, solicitors also have the right to appeal a decision of their disciplinary tribunal to the High Court (s.49 of the Solicitors Act 1974), a valuable right as demonstrated by the recent decision of Beckwith v Solicitors' Regulation Authority [2020] EWHC 3231 (Admin). Whichever of those routes may apply (dependant upon the subject matter of the relevant decision), proportionate access by regulated firms and individuals to independent judicial scrutiny wholly outwith the framework of the FRC is essential. We do not consider that it is appropriate for there to be a lower level of external scrutiny in relevant cases applicable to FRC than for such other regulators as are referred to above. Our experience is that recourse to the High Court affords confidence in the fairness of a regulatory regime - as in Beckwith, the High Court has demonstrated that it is prepared to disagree with regulatory decisions where it considers that they are wrong and unjust – and we consider that such recourse is likely, long-term, to improve the quality of Tribunal decisions.

Conclusion

45. Whilst some of the proposed revisions to the AEP mirror existing arrangements in the Accountancy Scheme, there are nevertheless a few improvements which should equally be made to the Accountancy Scheme. We would therefore welcome a similar consultation process in respect of the Accountancy Scheme once this process has run its course.

46. We are also aware that the revised AEP will ‘live and breathe’ in the forthcoming guidance, e.g. in respect of disclosure. We would welcome an equivalent opportunity to comment on such guidance before it is finalised.

Clyde & Co LLP

7 October 2021