

ClientEarth Investor Briefing

FRC failures are increasing risks for investors

The FRC's failure to effectively oversee and enforce corporate reporting laws has serious implications for investors – especially where climate risk is concerned

Is the FRC doing its job?

The FRC is facing mounting criticism regarding alleged failures to provide proper oversight of the audit profession – most recently in its review of the HBOS audit. KPMG's audit of HBOS in 2007 preceded the second biggest failure in British banking history. The financial statements – audited by KPMG – reported a profit before tax of £5.5 billion but eight months later the bank went bust. A recent decision by the FRC states that KPMG did not do anything wrong.

In addition to audit oversight, the FRC is also responsible for ensuring corporate reports comply with the law. In this area too, the regulator's actions are creating cause for concern on whether it is providing effective oversight and enforcement where companies do not comply with the law.

An oversight and enforcement gap is particularly acute in relation to reporting of climate-related financial risk, as evidenced by:

- the FRC's failure to send a strong message to the market in response to regulatory complaints submitted during 2016 regarding failure to report climate-related financial risk by two oil and gas companies; and
- the FRC's unsupportive stance in relation to the recommendations of the Task Force on Climate-related Financial Disclosures (which sets it apart from other financial regulators).

In our view, this oversight and enforcement gap is exacerbated by significant structural weaknesses which inhibit the FRC's governance, transparency and accountability – meaning the usual safeguards and mechanisms for investors to ensure the FRC is fulfilling its regulatory role are absent.

FRC failing on climate risk oversight

In August 2016, ClientEarth submitted regulatory complaints to the FRC in respect of SOCO International Plc and Cairn Energy PLC. As oil and gas exploration and development companies, transition risks and physical risks related to climate change have clear financial materiality for both companies. Our complaints alerted the FRC that – by failing to address climate-related financial risks – both companies' strategic report failed to provide:

- a fair review of the company's business and a proper account of the main trends and factors likely to affect the future development, performance and position of the company's business; and/or
- a proper description of the principal risks and uncertainties facing the company.

These failures to satisfy specific reporting requirements also prevent shareholders from assessing how the directors have performed their duty to promote the success of the company.

It was only in July 2017 – nearly a year after the complaints were submitted – that the FRC informed ClientEarth of the outcome of their investigation in a letter which stated:

- the Corporate Reporting Review Committee exchanged correspondence with SOCO and Cairn on the matters raised in the complaints. However the cases were closed without appointing a review group because of the companies' explanations combined with their proposals for future reporting; and
- as a result, the FRC review of SOCO and Cairn did not take a view regarding a potential breach of reporting requirements by either company, and the FRC did not consider it necessary to issue a press announcement or request that SOCO or Cairn refer to the review by the FRC.

The paucity of this information, the closed-door manner of the investigation, and the lack of any decision about whether the strategic reports complied with the law, all point to an excessively permissive regulator stance on this issue. This does not provide clarity on what the reporting requirement entails and is confusing for companies and investors. The regulator plays a central role supporting market confidence, but with that confidence undermined many investors may well doubt that annual reports provide a fair review of the companies they are invested in.

Worries about the FRC's attitude to enforcing climate risk reporting rules also stem from its response to the Phase II consultation of the Task Force on Climate-related Financial Disclosures. This response is at odds with other financial regulators in the UK (e.g. the Bank of England) and elsewhere.

The TCFD recommendations are emerging as a global standard and the key means by which investors can access information to assess, price and manage climate-related risks. The Task Force was set up by the FSB at the request of the G20, and its membership is comprised of investors, lenders, insurers and other stakeholders. It has been described by the Bank of England Governor Mark Carney as *a solution for the market, by the market*.

Yet the FRC's public statements on the TCFD recommendations appear to be broadly resistant to their general intent. These statements emphasise that the complexity and detail of the recommendations may impair their usefulness, and downplay the role of regulators in implementing the TCFD recommendations. Further, by conflating climate risk with other environmental issues, the FRC's statements fail to appreciate the magnitude of the risk.

The BEIS climate change minister has officially endorsed the TCFD recommendations. But the FRC – as the sole regulator responsible for oversight and enforcement of corporate reporting in the UK – is the key means by which to effect this. Without FRC support, a crucial part of the regulatory framework for managing climate risk is missing. In the absence of clear guidance from the FRC, investors' confidence in the quality and consistency of climate risk disclosures will be greatly limited.

Key safeguards absent

The FRC's excessively permissive stance on climate-related financial risk is even more troubling in light of significant weaknesses we have identified in its governance, transparency and accountability. These comprise:

- **Weak legislative basis:** Unlike other financial regulators in the UK, the FRC's functions and structure are not explicitly set out in legislation. The lack of a clear statutory footing means that many areas of the FRC's work are not subject to oversight by Government, Parliament or the public, and limits the transparency and accountability which would otherwise be expected from an important regulatory body.
- **Weak formal accountability to BEIS:** The primary accountability mechanism to BEIS is set out in a Memorandum of Understanding between the FRC and BEIS's predecessor. The lack of clarity about the FRC's statutory and regulatory functions, combined with the informal nature of this MoU significantly undermines the extent to which the FRC can be held accountable to its requirements. This means BEIS may have limited legal recourse where the FRC fails to act in accordance with the terms of the MoU.
- **Weak accountability to Parliament:** The FRC has limited formal accountability to Parliament in relation to its activities overseeing company reports. Legislation does require the FRC to report to Parliament about oversight of the audit profession – but it is not similarly so required in relation to oversight of corporate reports.
- **Weak accountability to the public:** The FRC's decisions may be subject to judicial review but (due to lack of transparency) it is often difficult to obtain the information necessary to establish a challenge. This problem is exacerbated by recent changes to the operating procedures which decrease the extent to which the public can access information. Unlike other financial regulators, the FRC appears to be subject to freedom of information requests only to a limited extent.
- **Weak conflict and governance safeguards:** The FRC has significantly less rigorous legal requirements regarding conflicts of interest than other financial regulators. In addition the constitutional structure makes directors the members of the company. As the members have primary means to hold directors accountable, the fact they share the same identity means they are very unlikely to do so.

In our view, these structural weaknesses compound the problem of lack of oversight and enforcement, and lack of confidence in reported information, because the proper safeguards and mechanisms for investors to ensure the FRC is fulfilling its regulatory role are absent.

What can investors do?

The oversight and enforcement gap for climate-related financial risk coupled with wider failings at the FRC is harmful to investors and the wider economy. In addition to engaging with the FRC directly, many investors are calling on the Government to address these failings through structural reform. We would encourage investors to support the [position paper](#).

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