June 2019

ClientEarth

ClientEarth response to the independent review of the Financial Reporting Council – initial consultation on the recommendations

1 Introduction

ClientEarth is a non-profit environmental law organisation based in London, Brussels, Berlin, Warsaw, Madrid, New York and Beijing. ClientEarth's climate finance initiative conducts research and advocacy in relation to the legal implications of climate change-related financial risks for a wide spectrum of market participants, including companies, investors, company directors, their professional advisers and regulators.

In March 2019, the Department for Business, Energy and Industrial Strategy (**BEIS**) issued an initial consultation on the recommendations of the Independent Review of the Financial Reporting Council (**FRC**) (**Consultation**). This document provides ClientEarth's response to the Consultation, including our key messages and comments in relation to selected questions relevant to our expertise.

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2 Key messages

1. We are pleased to respond to this consultation on the Independent Review of the Financial Reporting Council. ClientEarth has extensive experience in reviewing annual reports of UK companies for compliance with accounting and reporting requirements. Over the past ten years we have reported numerous companies to the Financial Reporting Council (**FRC**) and, more recently, the Financial Conduct Authority (**FCA**) for their failures to disclose material information about environmental and climate change-related trends and risks in their annual reports.[1] In 2018 we also sent public letters to each of the 'Big 4' audit firms to request information about how risks and impacts associated with climate change are taken into account in their audits.[2]

2. Despite wide-spread recognition that the financial risks and impacts associated with climate change and the zero carbon transition are some of the biggest mega-trends facing business today, we have observed a highly divergent and inconsistent approach taken by companies and their auditors in addressing these issues in financial accounts, narrative reports and audit reports. In light of the strong demand from investors, regulators, and other stakeholders for robust disclosures of the financial risks and impacts associated with climate change, we believe this current state of affairs is highly unsatisfactory.

[1] See, eg, ClientEarth, EasyJet among companies reported to regulator by ClientEarth, https://www.clientearth.org/easyjet-among-companies-reported-to-regulator-by-clientearth/

[2] See, eg, ClientEarth, Letter to EY regarding audit of EnQuest plc, https://www.documents.clientearth.org/wp-content/uploads/library/2018-05-09-letter-to-ey-regarding-enquest-plc-audit-ce-en.pdf

3. Alongside our specific concerns about the reporting of risks and impacts associated with climate change and other environmental issues, our experience has also provided us with significant insights into the broader dynamics of the UK's existing corporate governance and reporting framework, including its supervision and enforcement. In our view, the current framework, overseen by a week and fragmented regulatory architecture, is no longer fit for purpose. Reforms to address these issues and improve the overall quality, effectiveness and accountability of the UK's corporate reporting and governance framework are essential.

4. For this reason we are pleased to see that the government is taking steps towards reform. However, we are concerned that many of the proposed recommendations and the government's responses fail to solve the underlying problems of a fragmented regulatory framework and inadequate accountability and enforcement mechanisms. We address these concerns in our responses to the specific questions contained in the Consultation. In addition we would like to highlight following key messages, which we believe are of greatest importance:

    - The new regulator should be responsible for administering, supervising and enforcing the UK's company law regime as a whole, and its functions should therefore reflect this.
    - The new regulator's objectives, principles, functions and powers need to be more clearly articulated.
    - The new regulator's functions must explicitly include reference to its supervision and enforcement roles.
    - The new regulator must have powers to directly enforce company reporting requirements against a company, its directors and auditors in relation to the entire annual report.
    - Reforms to corporate governance and reporting laws must include improved public and private oversight and enforcement of directors' duties.

5. Each of these key messages is elaborated on further in response to the questions below. Please note, we have not responded to questions which we believe fall outside of our particular experience and expertise.

3 Responses to questions

Q1. What comments do you have on the proposed objective set out in Recommendation 4?

6. We agree that the new regulator should have a clear strategic objective to guide the exercise of its functions and powers. However we are concerned that the proposed objective for the new regulator does not adequately address the fragmented and inconsistent approach to the oversight and enforcement of company law, corporate governance, corporate reporting and audit in the UK. These areas are deeply interconnected and unless there is a single body with responsibility spanning all these areas, we believe the proposed reforms will not be effective in achieving their intended outcomes and restoring trust in the UK's corporate governance and reporting regime.

7. In our view, it is imperative that there is a single regulator which combines the existing responsibilities of the Insolvency Service, Companies House, the FRC and some functions of the Financial Conduct Authority (FCA) to provide a joined up approach to the supervision and enforcement of UK company law, including corporate governance, reporting and audit.

8. Accordingly, we believe the objective proposed in Recommendation 4 needs to be amended to read as follows:

   Objective: *to administer, supervise and enforce the UK's company law regime in the interests of investors and the public, including by setting high standards for corporate reporting, corporate governance and audit and pursuing appropriate supervisory and enforcement action.*

9. In the event that the proposed narrower objective is pursued then we believe that it should at the least be made clear that the new regulator should be responsible for protecting users of all company information, and not just narrowly defined 'financial information'. This would better reflect the way in which company information is now produced and used by investors and other stakeholders, including in relation to broader environmental, social and governance (ESG) risks and impacts. In addition, the new regulators objectives in carrying out supervision and enforcement of the law and standards relating to corporate governance, reporting and audit must be made explicit.

Q2. What comments do you have on the duties and functions set out in Recommendations 5 & 6?

10. We agree that it is important that the new regulator has clear objectives, principles and functions. However, we believe that the approach proposed in Recommendations 5 and 6 is confusing; that the relationship between the 'duties' and 'functions' is unclear; and that core functions in relation to the administration, supervision and enforcement of company law and associated governance, reporting and audit standards are not adequately addressed. In addition, the new regulator's powers should also be clearly articulated.

11. Many of the 'duties' proposed in recommendation 5 are important principles or strategic objectives, however we consider that given their generality, calling many of them 'duties' is a mischaracterisation and could lead to confusion. In our view there should be a clear and transparent relationship between the new regulator's overarching objective (discussed above), it's strategic objectives or regulatory principles (such as those referred to in Recommendation 5), and detailed and comprehensive articulation of functions and powers granted by statute (which must be exercised in accordance with the objectives and principles).

12. Recommendation 6 only provides an incomplete articulation of the new regulator's functions. As set out in our response to Question 1, we believe that the new regulator should be responsible for administering, supervising and enforcing the UK's company law regime as a whole, and that its functions should therefore reflect this. At the very least, we believe that it needs to be made clear that the new regulator is responsible for supervising and enforcing duties on companies and directors in relation to corporate reporting and governance, as recommended by the Kingman Review and referred to elsewhere in the Consultation (Chapters 2 and 3).

13. In this respect, we believe that the biggest failing by the FRC has been its failure to adequately enforce the law relating to reporting and audit, and to use the powers granted by

the Companies Act and related legislation effectively in order to do so. For this reason we believe that 'enforcement' must be referred to explicitly in the new regulator's functions rather than just implicitly through requirements to 'set and apply' corporate governance, reporting and audit standards. In addition, the failure to refer to the new regulator's role in supervising and enforcing compliance with the law, and the Companies Act in particular, may undermine the new regulator's achievement of its objectives and its external perception.

Q3. How do other regulators mitigate the potential for conflict between their standard setting roles and enforcement roles as set out in Recommendation 14?

14. We do not have a view about how other regulators mitigate the potential for conflict between their standard setting roles and enforcement roles. However we strongly believe that a high level of independence between these separate functions needs to be maintained. Unless this is achieved there is a significant risk that standards will be watered down to make supervision and enforcement easier and/or enforcement action watered down to cover up potential deficiencies in how the standards and guidance implement the law.

Q4. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

15. We strongly agree that the board and structure of the new regulator needs to be clearer and more streamlined than the existing FRC structure, with clear lines of responsibility and accountability. In our view, this is particularly essential in relation to the new regulator's supervision and enforcement functions.

16. As we have experienced with our complaints to the FRC regarding failures by companies to adequately report climate change-related risks in their annual reports, the current enforcement process adopted by the FRC Conduct Committee and set down in its operating procedures is confusing, complicated and opaque. It is very unclear when and how decisions must be reached and the operating procedures permit a very high level of discretion which severely undermines confidence, credibility and due process.

Q5. How will the change in focus of CRR work to PIEs affect corporate reporting for nonpublic interest entities?

17. We do not propose to respond to this question.

Q6. What are your views on how the pre-clearance of accounts proposed in Recommendation 28 could work?

18. We do not propose to respond to this question.

Q7. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

19. We agree that it is critical that the new regulator's powers in relation to its core functions are strengthened and extended. As noted in our response to Question 1, we believe that the new regulator should be responsible for administering, supervising and enforcing the UK's company law regime as a whole, and that its functions should therefore reflect this. In our view, this is essential to ensure that there is a joined up approach to the supervision and enforcement of UK company law, including corporate governance, reporting and audit, in the

interests of investors and the broader public. That being said we make specific comments below in relation to recommendations regarding the new regulator's proposed functions regarding corporate reporting, directors' duties, audit and stewardship.

Corporate reporting

20. ClientEarth has extensive experience in reviewing annual reports of UK listed companies for compliance with disclosure requirements. Over the past ten years' we have reported numerous companies to the FRC and (more recently) the FCA for their failures to disclose material information about environmental and climate change-related trends and risks in their annual reports. This has included the following:

- BP plc (complaint to the FRC Financial Reporting Review Panel – 2010)
- Rio Tinto plc (complaint to the FRC Financial Reporting Review Panel – 2010)
- Cairn Energy plc (complaint to the FRC Conduct Committee – 2016)
- SOCO International plc (complaint to the FRC Conduct Committee – 2016)
- Admiral Group plc (complaint to the FCA – 2018)
- Phoenix Group Holdings (complaint to the FCA – 2018)
- Lancashire Holdings Limited (compliant to the FCA – 2018)
- EasyJet plc (complaint to the FRC Conduct Committee – 2018)
- Balfour Beatty plc (complaint to the FRC Conduct Committee – 2018)
- EnQuest plc (complaint to the FRC Conduct Committee – 2018)
- Bodycote plc (complaint to the FRC Conduct Committee – 2018)

21. The core issue at the heart of these complaints has been whether or not a company has properly disclosed 'material' information as required by the Companies Act and associated guidance provided by the FRC. In every case so far, the relevant regulator has failed even to communicate a decision about whether or not the report in question complies with the law – let alone to pursue any remedial actions or sanctions. In our view this is highly unsatisfactory and results in a situation where investors and other stakeholders can have little confidence that the information included in annual reports is fair, balanced and reasonable and includes all material information relevant to their decision-making.

22. More generally, we note that the approach taken by the FRC to enforcement of corporate requirements generally is severely out of step with the approach taken in other countries. In 2016/17, for example, the FRC conducted just 203 reviews of corporate reporting, out of which no corrections were required and just three companies were required to publish details of the FRC's review.[3] This approach has been criticised directly by the European Securities and Markets Authority (**ESMA**) in its Peer Review Report on Enforcement of Financial Information, where it concludes that:

> *"the decisions taken by the FRC with regard to correcting material errors in financial statements are too weighted towards permitting those corrections to be made in future*

[3] See FRC, 'Annual Review of Corporate Reporting' (2016/17) https://www.frc.org.uk/getattachment/311af48c-bdfa-4484-8e7d-6de689fd8f4b/Annual-Review-of-Corporate-Reporting-2016-17.PDF

financial statements, rather than ensuring that the issuer makes the correction publicly and much earlier in a corrective note."[4]

23. This overly permissive approach is also highly anomalous compared to other key jurisdictions. One clear example is the regular corporate reporting review and comment process undertaken by the US Securities and Exchange Commission (**SEC**). By statute, the SEC must review the corporate report of every issuer at least once every three years (though it typically reviews the reports of 50% of all issuers each year). Where it has questions about either the financial or narrative components of the corporate report, it provides issuers with a comment letter, describing its concerns and requesting a written response from the issuer. Issuers must then provide that response and the entire exchange is publically available. If the issuer's response satisfies the SEC's inquiry, the SEC issues a formal letter acknowledging as much. If it does not, the SEC issues a restatement notice, which may require the issuer to amend the report.

24. In 2017, the SEC required 553 reissuance restatements for deficient financial reporting. As noted above, in the 2016/17 year, the FRC required zero corrections. We are also not aware of any formal action taken by the FCA in this regard to fulfil its own duties to oversee and enforce compliance with disclosure requirements for issuers under the FCA Handbook and Listing Rules.

25. In light of these concerns, we welcome the recommendation that the new regulator expand its supervision of corporate reporting and we recommend that this should be done on a scale equivalent with other similar jurisdictions. We also welcome the recommendations that the new regulator must have direct powers to enforce compliance with the requirements in the Companies Act; and that the results of findings and correspondence will be made public. This is particularly important to ensure that other companies and financial market participants have the benefit of understanding the regulator's approach to key issues such as materiality judgments and accounting estimates and assumptions.

26. In relation to wider corporate reporting, it is widely recognised that increasing weight is placed by investors and other stakeholders on both qualitative and quantitative information about risks and impacts facing a business (including KPIs, scenario analysis and stress testing results, and other targets). This now includes a wide range of information about environmental, social and governance (ESG) issues which investors consider financially material for their investment and stewardship decisions and necessary to substantiate their claims to consumers in relation to 'green' or 'sustainable' investment products. This information is also used by a wide range of other stakeholders to inform economic and regulatory decisions.

27. We note that the FRC has for some time already had responsibility for overseeing wider corporate reporting beyond the financial accounts (both for the purposes of the Companies Act and the Listing Rules).[5] Despite this, it has almost entirely failed to take any meaningful

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[4] ESMA, 'Peer Review on guidelines on Enforcement of Financial Information' (2017) [74] https://www.esma.europa.eu/sites/default/files/library/esma42-111-4138_peer_review_report.pdf

[5] The Conduct Committee has been authorised by the Supervision of Accounts and Reports (Prescribed Body) and Companies (Defective Accounts and Directors' Reports) (Authorised Person) Order 2012/1439, for the purposes of section 456 of the Companies Act, to make an application to court for a declaration that the strategic report of a company does not comply with the requirements of the Companies Act and for an order requiring the directors of the company to prepare a revised report.

Under section 14 of the Companies (Audit, Investigations etc) Act 2004, the Conduct Committee is also responsible for keeping under review periodic accounts and reports that are produced by issuers of transferable securities and are required to comply with any accounting requirements imposed by

enforcement action. As a result there is a low level of confidence in the quality and reliability of much of this broader financial and non-financial information included in annual reports.

28. From our observations there are currently significant problems with 'green washing' and 'bright-siding' in relation to this information, which means that it often conveys a misleading picture for users of annual reports or is otherwise very poor quality. Because of the extent to which this information is now relied on by investors, regulators and other stakeholders, we believe that it is critical that this information is fully integrated into the new regulator's supervisory and enforcement functions.

Directors' duties

29. Recent high profile corporate governance scandals and ClientEarth's own experience have shown that accountability and enforcement of corporate reporting and governance laws in the UK are grossly inadequate. In this context, we believe that reforms to ensure better oversight and enforcement of directors' duties are critical. This should include reforms to enable better regulatory supervision in the public interest, as well reinforcing mechanisms for private accountability by key stakeholders such as shareholders and creditors.

Public oversight and enforcement

30. In relation to improved public oversight and enforcement of directors' duties for preparing and approving annual accounts and reports we are very supportive of the proposals to develop a more effective enforcement regime to ensure that directors are properly held to account for actions and information which they are ultimately responsible for. Because directors' fulfilment of their duties have wide implications for a wide range of stakeholders, including shareholders, creditors, employees, regulators, pension fund members and the broader public, it is critical that there is a strong regulatory mechanism for enforcing breaches of duties in relation to reporting and governance. In this respect, the current powers and capacity of the Insolvency Service to disqualify directors for fraud or wrongful trading are entirely inadequate and out of step with the approach in other key jurisdictions.

31. In Australia, for example, a strong regulatory enforcement mechanism has been introduced for breaches of directors' duties, whereby, if a court is satisfied that a director has contravened a core directors' duty, it can impose a financial penalty, and disqualify the director. If a director breaches one of these duties and they are found to have been reckless or intentionally dishonest, they may also be found guilty of a criminal offence.

32. This regime is enforced by ASIC, which has been granted extensive powers to investigate suspected breaches of the law, require the production of information, issue infringement notices, seek civil penalties from the courts and, in some cases, to commence criminal prosecutions. ASIC has investigated, referred and prosecuted a significant number of cases where directors of Australian companies have breached their core duties. Evidence indicates that judicial proceedings brought by ASIC or referred to the Director for Public Prosecutions perform a significant role in the enforcement of directors' duties, constituting approximately half of all public and private proceedings involving breaches of directors' duties.[6]

Part 6 rules, and if the Conduct committee thinks fit, informing the Financial Conduct Authority of any conclusions reached by the body in relation to any such accounts or report.

[6] See Jasper Hedges et al. 'An Empirical Analysis of Public Enforcement of Directors' Duties in Australia', CIFR Paper No. 105/2016

33. We believe that the adoption of a similar regulatory regime in the UK would provide an effective means of ensuring that the statutory duties of UK company directors are enforced in alignment with the interests of investors, other stakeholders and the public interest.

Private enforcement and oversight

34. Alongside reforms to the public oversight and enforcement of directors' duties in relation to corporate governance and reporting, avenues for private enforcement by shareholders and others must also be improved. Currently, the primary means by which directors can be held accountable by shareholders for breaching there duties is through the derivative action scheme contained in the Companies Act (Part 11). Numerous commentators,[7] and government and government reports,[8] have identified that this scheme is inadequate.

35. The current scheme was intended to balance the need to provide shareholders with an effective private mechanism to enforce directors' compliance with their statutory duties, while ensuring that directors' proper activities are not inappropriately disrupted. As noted in the commentary cited above, we believe that the complexity of the derivative claim process tips this balance too far against the interests of shareholders, overly limiting any basis on which boards can be challenged and director's duties enforced.

36. We believe that this balance can be appropriately restored by strengthening the derivative action scheme by:

- broadening the range of applicants that can bring proceedings under the action to include shareholders, former shareholders and any other person who, in the discretion of a court, is a proper person to make an application;
- expanding the range of actions for which a derivative action can be brought;
- providing courts with discretion to order payments to current or former shareholders;
- requiring permission or leave from the court before settlement or discontinuation of an action, to prevent claimants being 'bought-off'; and
- removing shareholder ratification as a bar to the granting of leave for derivative action proceedings.[9]

37. Under the UK's current corporate reporting and governance framework, company directors are ultimately responsible for the performance of the company and its disclosures. Unless directors themselves are held properly accountable through new and additional public and private enforcement mechanisms, as described above, reforms to introduce a new regulator and address failings in the audit sector will fall short. As we have noted elsewhere, we also strongly believe that the work of the Insolvency Service must be brought within the ambit of the new regulator to avoid a disjointed approach to enforcement.

[7] Andrew Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006', Journal of Corporate Law Studies 16 (2016) H. Hirt, The Enforcement of Directors' Duties in Britain and Germany (Peter Lang: Bern, 2004); D. Ahern, 'Directors' Duties: Broadening the Focus Beyond Content to Examine the Accountability Spectrum' (2011) 33 Dublin University Law Journal 116; R. Garratt, 'We Must Make Boards Better' Sunday Times, 9 January 2011; A. Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33 Civil Law Quarterly 76.

[8] Department for Business Innovation and Skills, Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business, Discussion Paper (Department for Business Innovation and Skills: London, 2013) para. 8.13

[9] See further, Andrew Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006', Journal of Corporate Law Studies 16 (2016).

Audit

38. We have separately responded to the independent review into the quality and effectiveness of audit being conducted by Sir Donald Brydon. The key messages which we identified in our response are as follows:

- Existing accountability and enforcement mechanisms for corporate reporting and directors' duties are inadequate. Reforms to improve the quality and effectiveness of audit are important and necessary but unless they are made alongside reforms to improve both public and private oversight and enforcement of directors' duties for corporate governance and reporting, they will fail.[10]

- Auditors work in relation to 'other information' and principal risks and uncertainties facing a company is inconsistent and inadequate, even under existing requirements. Reforms to improve both public and private enforcement of auditors duties are necessary to ensure better quality audits.

- Reforms to improve the quality and effectiveness of audit must take into account evolving trends regarding investors' concerns about environmental, social and governance (ESG) risks and impacts, particularly in relation to climate change-related risks and impacts.

- Directors and auditors must be more accountable to all reasonable users of annual reports, including existing and potential shareholders and creditors (collectively AND individually), government regulators (eg. tax authorities and financial and prudential regulators), trustees of company pension funds (where applicable), customers, employees and broader stakeholders.

- Ultimately, auditors must be required to perform and provide opinions in relation to a fully integrated audit of the entire annual report.

Stewardship

39. We have separately responded to the recent consultation on proposed revision to the UK Stewardship Code (Code). Among other things, in our response, we propose that:

- the Code should make clear that most signatories will have statutory and common law duties to act in the best interests of their beneficiaries or clients, to say nothing of any contractual duties that may exist. There should be no doubt that these duties necessarily extend to undertaking or advising on stewardship activities as formulated in the new Code; and

- the Code should be made mandatory and the new regulator should be provided with enforcement powers to ensure that it is followed and meaningfully reported against.

Q8. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

[10] Because this issue is not explicitly addressed by the questions contained in the call for views for the Consultation, we have included further details in a separate Annex at the end of our Submission.

40. As noted in our response to Question 1, we believe that the new regulator should be responsible for administering, supervising and enforcing the UK's company law regime as a whole, and that its functions should therefore reflect this. This should necessarily include a forward-looking market intelligence function, and strong powers to intervene and investigate non compliance by the company and its directors in relation to corporate governance and reporting failures. This should be reinforced by improved public and private accountability and enforcement mechanisms as described in our response to question 7 above.

Q9. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

41. We do not propose to respond to this question.

Q10. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

42. Our experience in engagement with the FRC is that it has been severely under resourced in terms of capacity, expertise and capability. We therefore welcome the proposals to ensure that the new regulator is provided with greater funding and resources and look forward to participating tin the associated consultations in due course.

Q11. Are there specific considerations you think should be borne in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

43. We do not propose to respond to this question.

Q12. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

44. We do not propose to respond to this question.

Q13. What evidence or information do you have on the costs and benefits of these reforms?

45. We do not propose to respond to this question.

Q14. What further comments do you wish to make?

46. We do not propose to respond to this question