TRANSPARENCY AND TRUST DISCUSSION PAPER RESPONSE

16 September 2013

CA House 21 Haymarket Yards Edinburgh EH12 5BH
enquiries@icas.org.uk +44 (0)131 347 0100 icas.org.uk

Direct: +44 (0)131 347 0231 Email: atelfer@icas.org.uk

Executive Summary

Introduction

1. The Institute of Chartered Accountants of Scotland ("ICAS") is the oldest professional body of accountants, ICAS represents around 19,000 members who advise and lead businesses across the UK and in almost 100 countries around the world. We regulate circa 75% of insolvency practitioners (IPs) who take appointments in Scotland and we have an in-depth knowledge and expertise of insolvency law and procedure. ICAS regulated IPs play a key role in delivering a trusted business environment in the UK through the investigation and reporting of director misconduct or criminality identified as part of insolvency proceedings.

2. ICAS's Charter requires it to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

3. ICAS welcomes the opportunity to submit its views on the discussion paper: Transparency & Trust: Enhancing the transparency of UK company ownership and increasing trust in UK business published by the Department of Business Innovation & Skills in July 2013.

Comments on Part A

4. We support the principle of greater corporate transparency, making it easier to identify business owners and for government actions to address structures that obstruct transparency for criminal activity. The proposal to include a new requirement for companies to obtain and hold information on their beneficial ownership through a central register maintained by Companies House appears reasonable. It is essential that further clarification is provided on how this would be policed. A clear mechanism is needed for monitoring and enforcement to ensure that any changes in the legislation will be effective.

5. Company Law appears to have a high level of compliance, due in part to the work of professionals, yet there is not a clear framework in place for dealing with wider breaches of the Companies Act by unregulated private companies. This is manifested in the fact that existing legislation is sparingly used with very few cases brought to court.

6. For illustrative purposes, third party verification by audit (for eligible companies) includes compliance with those matters in the Companies Act 2006 related to the annual report and accounts. ICAS has identified instances of non-compliance, which may result in additional disclosure in the accounts, yet no formal action is pursued when the accounts are submitted to Companies House[1].

7. For unregulated private companies (not listed) there does not seem to be a clear contact point to report concerns of Company Law breaches, which will pursue investigation and enforcement. The Directors Disqualification Unit is rarely used; the Financial Reporting Council (FRC) deals only with financial reporting and Companies House do not get involved in wider compliance issues. The existing approach is quite fragmented and focuses on particular aspects only such as the Serious Fraud Office (SFO) for big serious fraud investigations and money laundering reporting.

8. As a comparative, the charity sector has a regulator to report areas of concern, being the Charities Commission in England and Wales and the Office of the Scottish Charity Regulator (OSCR). They will investigate and make recommendations but they also have the ability to impose sanctions such as removing charitable status or requesting accounts to be restated and resubmitted. The key difference is that OSCR will reject accounts not only for administrative and presentation issues but

[1] *ICAS has seen examples of a company requiring an audit but not engaging an audit, either deliberately or through error (such as following a period of rapid growth). This usually arises when one of our members is the new appointment and discovers that an audit has not been carried out for a period of years and ICAS is approached to advise how to resolve this. There are also examples of illegal payment of dividends (sometimes followed by the company going bust) which may result in additional disclosure in the accounts.*

also technical accounting and statutory issues. In comparison, Companies House appears to reject accounts only for the former, administrative and presentation reasons. We believe it should extend to both i.e. technical and legislative reasons as well as presentation and administrative issues.

9. We suggest that the role of Companies House is reviewed so that it is not just a body for filing and storing accounts but also undertakes more rigorous monitoring and consistent reporting of companies where breaches of the Companies Act have been identified to help improve enforcement levels. Companies House appears to be well placed to monitor and report breaches as they will maintain the central register and also receive all accounts and annual returns. This would reflect a 3 tier approach to prevent and detect breaches:
   (i) directors responsibility to ensure compliance;
   (ii) auditors check and report (if an eligible company); and
   (iii) Companies House acts as a last defence post to monitor and take notice of breaches identified in the annual return/accounts and audit report (where appropriate), reject accounts or escalate as appropriate.

10. We would also suggest that the discussion paper needs to be clearer on the role of offshore companies as there can be significant opacity around the ownership and directorship of these entities.

Comments on Part B

Clarifying responsibilities of directors in key sectors

11. We appreciate the driver for considering a new primary duty to promote financial stability/safety and soundness of the firm over the interests of shareholders for a particular sector however, there is insufficient evidence presented to support how this would be effective. It sets an unusual precedent and we have concerns that there may be unintended consequences. In the vast majority of cases, there should not be a conflict between promoting financial stability and shareholders' interests. The creation of a primary duty risks creating a conflict between this and some other duties. The effect of banking reforms should be evaluated prior to considering a need to create a primary duty for directors under the Companies Act provisions.

Allowing sectoral regulators to disqualify directors in their sector

12. We believe that the current system in place to deal with director misconduct is appropriate with director disqualifications supported by sectoral regulators having appropriate powers to also take action against misconduct. We believe that it should be for the Secretary of State to instigate director disqualification proceedings and that it is not appropriate for sectoral regulators to be responsible for pursuing director disqualification orders or undertakings.

13. The resources required for sectoral regulators to investigate and pursue director disqualification or undertaking proceedings would be a significant additional cost for those regulators. These costs would ultimately require to be recovered from the individuals or businesses working in those sectors. This is also likely to be a factor in business competitiveness on the world stage and the ability of the UK to attract businesses to trade from the UK.

14. At present, the Company Director Disqualification Act 1986 ("CDDA") sets out limited circumstances where a director of a solvent company can be disqualified. We believe that should there be a desire to extend director disqualifications for misconduct within regulated sectors then it would be more appropriate to extend these circumstances to include where a director has been found guilty of misconduct by a sector regulator and then require sector regulators to report these to the Secretary of State for investigation and consideration of disqualification proceedings.

15. We have noted in paragraph 5 that the level of enforcement of Companies Act 2006 breaches is low. A more rigorous monitoring and reporting mechanism for Companies Act breaches is required and that this would strengthen the director disqualification regime by bringing director misconduct to the attention of BIS at a much earlier stage.

Factors to be taken into account in disqualification proceedings

16. We do not believe that an amendment to Schedule 1 to the CDDA is necessary to allow the Secretary of State and Courts to take into account material breaches of sectoral regulation. Breaches of sectoral duties are already included within the scope of item 1 of Part 1 of the schedule and the Courts have sufficient latitude to take such matters into account in determining culpability and appropriate disqualification periods.

17. We do not believe that an amendment to Schedule 1 to the CDDA is necessary to take into account 'wider social impact'. Defining 'wider social impact' is likely to cause significant difficulty. We believe that the public interest test and the latitude that the Courts have in determining culpability and appropriate disqualification periods is already sufficient to deal with the impact of director misconduct.

18. We would not support amending Schedule 1 to the CDDA to specifically include having had particular regards to the protection of deposits, pre-payments or otherwise vulnerable creditors. The definition of 'vulnerable creditors' is likely to be problematic. We believe that the public interest test and the latitude that the Courts have in determining culpability and appropriate disqualification periods is already sufficient to deal with the impact of director misconduct.

19. We would urge caution in allowing tailoring of disqualification periods. It is likely that it will be difficult to sufficiently define company activities and the scope of disqualifications to make this a viable option. It is likely that policing such split disqualifications will be very difficult and therefore any amendment may have limited impact.

20. We would not support any presumption that a certain number of company failures is indicative of a director being 'unfit'. This risks impacting entrepreneurship within the UK. Certain sectors, such as high technology companies, research and development and university spin-outs, regularly have multiple failures for reasons other than those where director unfitness is an issue. Similarly, this approach could significantly affect the restructuring and turnaround community where specialist turnaround experts become involved in a company in distress. The presumption of being unfit as a result of multiple failures is likely to impact on such experts considering whether to become involved in certain companies. Where the possibility of turnaround becomes more marginal then such a policy is likely to result in an increase in appointments being declined and as a result an increase in the number of company failures. There are also potential issues for directors who are involved in group companies where multiple insolvency failures would be more prevalent. It is perhaps worth noting that on a practical level, directors with multiple company failures will have difficulty in securing finance for future businesses and therefore the marketplace currently places restrictions on directors with multiple company failures.

21. While we think that there may be some merit in taking into account directors previous failings we would urge caution in taking this forward. Without full investigation into previous company failures it will be very difficult to factor this on an evidential basis into Court decisions. It is clearly possible to rely on previous disqualification orders or undertakings and factual misconduct (failure to lodge accounts, HMRC creditor proportionality, etc.) however other failings may be more problematic to evidence if to be relied on in court subsequently. To some extend this is already taken account of as part of the public interest consideration in current disqualification considerations.

Improving financial redress for creditors

22. Our members report that actions for wrongful or fraudulent trading are relatively rare due to the high barriers of proof required to achieve a successful action in the Courts. There are many cases where there are indicators of wrongful or fraudulent trading however the costs in pursuing such claims and the barriers to successful claims are significant. Gaining the support of creditors in pursuing such claims is often problematic as they will not wish to incur additional expense (directly or indirectly through a possible reduced dividend) without certainty of a positive outcome.

23. The possibility of a liquidator assigning their right to a claim already exists in Scotland. Anecdotally our members report that this is an avenue that has been pursued on occasion either in return for a fixed payment on assignation or with an agreed split of any outcome (or a mixture) which of course benefits the creditors. The practical issues which arise include having to keep a case open for an extended period of time while the action is pursued and whether a third party is likely to have any better success in pursuing a claim than a liquidator. It is our experience however that the assignation of a claim remains relatively rare as the same barriers to pursuing a claim exist for a third party as a liquidator.

24. We would remain cautious on whether this proposal would have any significant impact on the outcome for creditors in the majority of insolvency cases.

25. We would support the proposal that administrators be given the right to pursue wrongful and fraudulent trading actions. We would however note that there is a presumption in legislation that administration exists only for 12 months and that it is unlikely that actions for wrongful or fraudulent trading would be completed in this timescale. This proposal therefore should be considered in conjunction with the Red Tape Challenge consultation and proposals to amend the extension of administration regime.

26. We would support the proposal that courts should be provided with the power to make compensatory awards against directors who are found guilty of misconduct under disqualification proceedings. If this was pursued then it would seem a sensible measure to include similar provisions for the Insolvency Service to be able to agree a compensation award when accepting an undertaking.

27. It would seem appropriate where compensatory awards were made or undertakings agreed that monies recovered by such action should be applied for the benefit of creditors generally. Practically however this may cause some difficulties as office holders would require to remain in office until proceedings were completed (which could be some years after appointment, particularly if the proposed extension to the period to raise disqualification proceedings were introduced) and compensation payments received before distributing to creditors. As an alternative, one suggestion would be to ring-fence such compensation awards and make this available to the Insolvency Service or IPs to use to pursue other actions against directors (e.g. wrongful trading, unfair preferences, misfeasance, etc.) provided for under the Insolvency Act 1986.

28. We note that some aspects may fall within powers devolved to the Scottish Government and our view is that any changes to the disqualification regime generally would require to be applicable throughout the UK and introduced in both legal jurisdictions simultaneously to ensure that there is parity in business operations in each legal jurisdiction.

Time limit for disqualification proceedings

29. We would urge caution in extending the time limit for the raising of director disqualification proceedings beyond the current 2 year period. It is noted that the discussion paper states that the time limit currently poses a problem in a minority of cases. Anecdotally our members also report that there are very few instances that they are aware of where proceedings have not been able to be brought within the relevant timescale.

30. Proposals to allow simplify the CDDA reporting requirements for IPs and to reduce the timescale for submitting reports from 6 months down to 3 months will also impact on this proposal.

31. It is noted that the powers already exist to allow the court to extend the period of time to raise proceedings. It appears that this power should already cover the scenarios where information is only discovered late in the period or where the case is exceptionally large or complicated.

32. Extending the period allowed to raise disqualification proceedings may also have an impact on the proposals in relation to compensation awards/orders against directors and the ability to flow this benefit through to creditors as noted in point 0 above.

Educating directors

33. We believe that if there is to be an education offering for directors it works best as a preventative measure to reduce the likelihood of failures rather than after the event. Our views is that this would operate best as a voluntary 'opt-in' model to avoid the risk that too many requirements may inadvertently deter entrepreneurs to set up business in the UK.

34. We are concerned that serious misconduct is unlikely to be avoided or prevented in recurring through education as often such behaviours are influenced more through individual ethical standards and behaviours and it is questionable how much impact could be made through education which would be self-funded.
35. We would question whether the reduction in disqualification tariff as a result of participating in a self-funded education programme would be appropriate. Without measuring a change in behaviour as a

result of the education then such a system could simply be perceived as a director 'buying' a reduction in tariff whilst going through the motions of education, particularly where the education was provided online.

36. The costs of developing and implementing an education programme could be significant and we consider that the return on investment is likely to be limited. If not compulsory, then those who elect to undertake the education are perhaps the ones more unlikely to fall guilty of misconduct which would warrant disqualification proceedings.

Extending overseas restrictions

37. In principle we would support regulations being made using the powers in Part 40 of the Companies Act 2006. It would seem prudent that where a person is subject to a foreign restriction that such an individual should be required to notify the Registrar of Companies in the UK if they are involved in a company in the UK. We do not believe that where foreign restrictions apply that they should apply automatically in the UK and consider that this should remain a matter for the courts to decide.

38. We believe that it would be a proportionate reaction to allow the Secretary of State to instigate disqualification proceedings against an individual who has been found guilty of a criminal offence in connection with the management of a company overseas. We believe that such an ability would increase the trust in UK companies.

We hope this is helpful. If you have any questions, please contact us as follows:

Part A accountingauditing@icas.org.uk
Part B icasinsolvency@icas.org.uk
ICAS
CA House, 21 Haymarket Yards
Edinburgh EH12 5BH
TEL: +44 (0) 131 347 0100
WEB: icas.org.uk