

FRC v Sports Direct International Plc ("Sports Direct"): the latest regulatory challenge on privilege

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In September last year, the FRC successfully obtained an order that an audit client disclose to the FRC privileged documents relevant to its investigation of the company's auditor.

The FRC's application was made under recent legislation enabling the FRC to obtain documents relevant to FRC investigations of Public Interest Entities (PIEs) direct from third parties, including the PIE itself. We shall see more of these applications in the future.

That decision raises issues for auditors and audit clients:

- Could an audit client lose privilege over documents disclosed to auditors?
- The FRC could argue that it will treat such privileged material as confidential. But is the FRC permitted / obliged to send this material to other regulators? What happens if the FRC needs to base a public Decision Notice on privileged material? What happens if the privileged material is then used as evidence before a Tribunal?
- Given these uncertainties, we are concerned that the Sports Direct decision could have a chilling effect on the willingness of PIEs to hand over privileged material to their own auditors.

The audit profession and audit clients are right to be concerned about this decision.

Summary

The FRC is investigating the conduct of the auditors in their audit of Sports Direct financial statements.

The FRC obtained disclosure of privileged documents from Sports Direct. The FRC relied on a new power under the Statutory Auditors and Third Country Auditors Regulations 2016 ('SATCAR'), successfully arguing that the disclosure did not actually infringe Sports Direct's privilege. This was because the documents would only be used by the FRC for the purpose of its investigation.

The FRC also argued that to the extent privilege was infringed by disclosure to the FRC, this was only a technical infringement. This was because the documents would not be used against Sports Direct, and so Sports Direct did not benefit from the applicable statutory protection. The judge agreed with the FRC "with some hesitation".

The decision is on appeal.

Comment

The starting point as acknowledged by the judge is that privilege is a fundamental human right "that can only be abrogated or overridden by primary legislation". In light of this, we think it surprising that the judge agreed with the FRC, albeit "with some hesitation", that SATCAR did not protect Sports Direct from having to make disclosure. The judge noted:

"[SATCAR] provides that a notice does not require a person to provide any information ..which that person "would be entitled to refuse to provide or produce in proceedings in the High Court on the grounds of legal professional privilege."

No infringement of privilege?

The cases concerning disclosure of privileged documents to regulators mainly concern disclosure to HMRC to ensure the correct amount of tax is paid, and to the Law Society to enable it to investigate compliance with The Solicitors Accounts Rules. These are narrow derogations from the general entitlement to privilege, so it is perhaps unsurprising that they have been upheld.

It may be relatively straightforward for the Law Society to limit its use of privileged material to investigating a solicitor's compliance with the Accounts Rules. And likewise for HMRC to limit its use of privileged material to tax calculations. However, an FRC investigation into the audit of a PIE encompasses the whole of the PIE's affairs, the directors' conduct of those affairs, and the legal position of the PIE vis-à-vis third parties - including where the PIE is in dispute with those third parties.

Audit clients are understandably concerned about this decision:

- The FRC's investigatory phase is confidential but the disciplinary phase is not. If the privileged information is relevant to an allegation or decision in the disciplinary proceedings, it will be taken into account and this risks publication, with the consequent loss of privilege.
- The conduct of a company's affairs is increasingly at risk of investigation, especially where the company's solvency is in doubt or its financial affairs are being publicly criticised. Privilege affords real protection so that the PIE and its board can take legal advice in a high-pressure situation. This argument is far from merely academic.
- Regulatory gateways allow the passing of information between regulators. It is not clear that privileged material would be protected from being passed to another regulator and then used in another regulatory investigation - this time, against the company and / or its board.

Analogous authority

Perhaps a comparison can be drawn between the court's approach to Sports Direct's privileged material and a recent decision of the Tax Tribunal, which refused to order disclosure to HMRC of audit working papers.

In a decision of 14 August last year [TC06710], the Tax Tribunal examined the statutory exceptions to HMRC's power to compel a third party to hand over information relevant to computing corporation tax. The Tax Tribunal recognised the tension between two competing public interests: ensuring the correct payment of tax, and safeguarding privileged material held by auditors. The decision against disclosure of the audit working papers turned upon a close analysis of the relevant statutory provisions. Perhaps a similar approach should be adopted towards disclosure to the FRC - namely, in the absence of an express statutory carve-out overriding an audit client's privilege, audit clients should not be required to disclose privileged information to the FRC.

In closing, we note that pending the appeal of the Sports Direct decision, audit clients will be concerned over disclosing privileged information to auditors. However, the practical implications are presently uncertain. For example, not handing over a privileged document to the auditor will not necessarily protect the PIE from having to disclose that document to the FRC. Moreover, there will be concern that the Sports Direct decision will prompt similar applications by regulators under different legislation. A clear decision from the Appeal Court is needed.

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