11 August 2014

FINANCIAL MARKETS LAW COMMITTEE

Richard Carter
Director
Department for Business, Innovation & Skills
1 Victoria Street
London SW1H 0ET

Dear Mr Carter

Audit Reform Legislation

The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which give rise to material risks, and to consider how such issues should be addressed.

The FMLC would like to draw the attention of the Department for Business, Innovation & Skills ("**BIS**") to areas in which legal certainty could be strengthened when adopting in the UK Regulation (EU) 537/2014 on specific requirements regarding statutory audit of public-interest entities (the "**Regulation**"). This letter will also refer to the directive amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts of all types of audited entities (including public-interest entities) (the "**Directive**"). Both the Regulation and Directive will apply to systemically important financial institutions.

The overriding aim of the Regulation and Directive is to improve audit quality and restore investor confidence in financial information. Whilst the FMLC welcomes this, it has key concerns regarding the transitional arrangement provisions and the effect these provisions may have on the wholesale financial markets in respect of the Regulation as well as the definition of public-interest entities under the Directive. The FMLC understands that BIS intends to provide guidance for the application of the Regulation and consult on implementing the Directive later this year. In light of this and to assist in the successful implementation, this letter summarises some suggested solutions to mitigate the key issues of legal uncertainty identified herein.

Transitional arrangements for mandatory rotation

Following the entry into force of the Regulation, public-interest entities will be required to change their statutory auditors or their audit firms every ten years as a maximum in accordance with Article 17 of the Regulation. Individual Member States are given the option to extend this period to 20 years where a public tendering process is conducted and 24 years where two or more firms are simultaneously engaged. Transitional arrangements will vary depending on the length of the audit appointment at the date the new rules come into force. By virtue of Article 41(1), if the auditor has been in place for 20 and more consecutive years as at the date that the Regulation comes into force, the first rotation must take place within six years. By virtue of Article 41(2) if the auditor

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has been in place for 11 and more but less than 20 years, the first rotation must take place within nine years. Transitional arrangements for audit appointments of less than 11 years are governed by Article 41(3), which provides that audit engagements that were entered into before the entry into force of the Regulation but which are still in place two years later may remain applicable until the end of the 10 year maximum period specified above (or 20 years where the engagement has been renewed).

Article 41(3) does not make clear when the maximum duration period should be deemed to begin, which leaves ambiguity as to whether the duration period begins on the date at which the Regulation enters into force or at the date at which the statutory auditor was first appointed. The FMLC has been given to understand that stakeholders have raised concerns as to the interpretation of these provisions. In particular, there is a concern that an interpretation whereby the period of maximum duration is deemed to begin from the date at which the statutory auditor was first appointed could result in the 10 year maximum duration being reached on the first day the legislation comes into force on 17 June 2016 in many cases. Accordingly, this would require an immediate auditor rotation or an immediate tender for a new auditor (where Member States adopt the extension optionality). This is arguably inconsistent with Recital 32 of the Regulation which notes that in order to

> ensure legal certainty and the smooth transition to the regime introduced by this Regulation it is important to introduce a transitional period regarding the entry into force of the obligation to rotate statutory auditors [...]

The consequence of the article as a whole, if this interpretation were adopted and in light of the approach taken in Article 41 paragraphs (1) and (2) to audit appointments of more than 11 years, would be that those entities with the shortest tenure audit appointments (<11 years) would be required to take action before those entities with the longest tenure audit appointments (>11 years). This would be an unusual legislative outcome.

Further, if Article 41(3) is construed to require immediate rotation on the coming into force of the Regulation, it would necessarily lead to a "cliff-edge" i.e. a point in time at which a large number of systemically important institutions must secure the provisions of a new auditor. Systemically important institutions often have complex global structures; it may therefore be difficult to secure adequate provisions of an auditor within a short period in circumstances of intense market pressure for those services. To the extent that this will make it hard for public-interest entities to obtain services, it may impede their ability to fulfil their statutory obligations and is likely to cause significant market disruption.

In contrast, an interpretation whereby the maximum period begins from the date on which the Regulation actually applies would be in line with the spirit of the overriding aims of the Regulation—that is, the longer the audit relationship, the shorter the transitional period and to contribute to the effective functioning of the internal audit market. It would also be more closely in line with general principles of non-retroactivity and legal certainty under European law.

The FMLC does not comment on issues of policy but considers there to be significant legal and operational uncertainty in respect of Article 41(3). It would be helpful if public-interest entities were given an advance indication of when the period in respect of Article 41(3) is deemed to begin, such that firms can consider the impact of the reforms and in particular, to audit tenders and auditor rotation.

FINANCIAL MARKETS LAW COMMITTEE

Definition of "branches"

By virtue of Article 3 of the Regulation, with the exception of "competent authority", all of the definitions set out in Article 2 of the Directive also apply to the Regulation. The Regulation applies to public-interest entities. There is however, uncertainty as to whether a branch of a non-EU credit institution or a branch of an insurance undertaking, which is based in the EU, where the parent is based outside the EU, is caught by the definition of "public-interest entities" which appears in the amended Directive and therefore, which has been incorporated into the Regulation.

Article 2(13)(b) of the Directive (as amended) extends the definition of "public-interest entities" to credit institutions and refers to Article 3(1) of Directive 2013/36/EU and Article 4(1) of Regulation (EU) No. 575/2013. These provisions, however, do not expressly state that in order for an undertaking to be classed as a credit institution it must be a corporate entity, raising the question whether a branch may in fact, be a credit institution. The FMLC infers from the fact that separate definitions for credit institutions and branches of credit institutions are provided in the legislation incorporated by reference in the Directive's definition that branches are not credit institutions and should not fall within the definition of public-interest entities. Clarification in respect of the position of a "branch" under the Directive and Regulation would assist in overcoming this uncertainty.

The FMLC hopes that the issues flagged in this letter are taken up for consideration by BIS. I and Members of the Committee would be delighted to meet with you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely

Joanna Perkins

Joanna Perkins
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Copied to: Paul Smith