Taxing Matters

Navigating the complexities of the tax world

RPC

Season 3

Episode 13 – The countdown to failure to prevent fraud is on (Part 2): What is failure to prevent fraud?

Alexis Hello, and welcome to Taxing Matters, your one stop audio shop for all things tax brought to you by RPC. My name is Alexis Armitage and I'm a Senior Associate in RPC's Tax Disputes team. I will be your guide as we explore the sometimes hostile and ever-changing landscape that is the world of tax law and tax disputes. Taxing Matters brings you a roadmap to guide you and your business through this labyrinth. In case any of you miss any crucial information or just want some extra bedtime reading, there is a full transcript of this and indeed every episode of Taxing Matters on our website at www.rpclegal.com/taxingmatters.

Hello, I am delighted to be back again today with our very own Tom Jenkins, who sits in the Tax, Investigations and Financial Crime team with me at RPC, for part two of this three-part mini podcast series on corporate criminal liability. As a reminder, if you didn't hear part one, Tom has extensive experience in conducting anti-corruption investigations and advising on the implementation and enhancement of compliance programmes. He has advised clients facing a wide range of white collar and regulatory defence challenges, including working on multi-jurisdictional investigations involving bribery and corruption, fraud and allegations of market abuse.

Last time, Tom and I looked at how English law has until recently attributed liability to companies. We also looked at a relatively recent amendment to the law that has changed that position. In this podcast today we will look at one particular way in which liability can be attributed to corporates using the failure to prevent offences, particularly the failure to prevent fraud offence that has received considerable attention over recent months and which will come into effect in September. In our final episode we will look at some potential future developments in this area. So Tom, here we go again, thank you so much for joining for part two.

Tom Thanks for having me again at Alexis, I'm looking forward to it.

Alexis So we talked last time about the Economic Crime and Corporate Transparency Act or ECCTA, as we're calling it for the purpose of this podcast, and the changes it has made to the law of corporate criminal liability. You mentioned that it introduced a specific failure to prevent fraud offence. Perhaps we can now turn to that.

Tom Right. So, ECCTA's other significant change in this area is the introduction of a new corporate criminal offence, which is known as failure to prevent fraud. This is one specific way in which ECCTA creates a rule for establishing the criminal liability of companies in the case of a set number of fraud offences.

The offence is set out at section 199 of ECCTA and creates an offence if a company fails to prevent its associated persons committing fraud offences that benefit the company, where the company did not have in place reasonable fraud prevention procedures.

Alexis Okay, so is this similar to the other failure to prevent offences we have become familiar with in recent years, like for example the failure to prevent the facilitation of tax evasion offence?

Tom Yes, and that's actually quite important context. So the failure to fraud offence is the third of these "failure to prevent" type offences that we have in English law. It follows the failure to prevent bribery offence, which came into force in 2011 under the Bribery Act, and the failure to prevent the facilitation of tax evasion offence, which is contained in the Criminal Finances Act and came into force in 2017. In many ways, new failure to fraud offence test operates in the same way as those offences have done over the years.

These failure to prevent offences present a particular approach to establishing the criminal liability of companies. They are strict liability offences, which means that the offence is established if the necessary acts took place, they don't require a prosecutor to demonstrate that the company intended the act to take place. Of those previous failure

	to prevent offences, the failure to prevent bribery offence has been used fairly extensively by prosecutors since it came into force in 2011. There have been a large number of high-profile enforcement actions against companies and they've included notable cases, for instance, against Airbus, Rolls-Royce, Glencore. There hasn't yet been a company charged under the equivalent facilitation of tax evasion offence, so that's something to watch for as well.
Alexis	So returning to how the new offense actually works, perhaps we can walk through some of the sort of component parts of it. So what is an associated person for these purposes?
Tom	People will be familiar with that concept from the bribery act in particular and the failure to prevent the facilitation of tax evasion offence. So there are a couple of different types of people who can be an associated person. So as a starting point, a company's employees, its subsidiaries and its agents will automatically be associated persons - that's a non-rebuttable presumption, those groups of people will always be a company's associated persons. Additionally, other people who perform services for or on behalf of an organisation will be its associated persons. And there's various categories of people that might include, and it will be fact specific and it'll depend on what the company does and how it uses its third parties, but it can include service providers such as consultants, distributors or resellers.
Alexis	And so what do we mean by fraud in this context?
Tom	Right, this is a good question and obviously the whole offence comes down to is a fraud offence. Unlike the Bribery Act when that came into force, which overhauled the entire criminal law of bribery in England and Wales, ECCTA doesn't actually create any new underlying fraud offences, nor does it make any amendments or changes to the fraud offences that are already in force. So to establish liability for the corporate failure to prevent fraud offence, a prosecutor will still need to demonstrate that the associated person has committed one of a specified list of already existing fraud offences. Those offences are set out in schedule 13 to ECCTA. And I'll just list them just because it gives a sense of the range of types of fraud that are covered. So we have a series of offences that fall under the Fraud Act: So we have fraud by false representation, fraud by failing to disclose information, fraud by abuse of position, and we have participation in a fraudulent business and obtaining services dishonestly- so they're all fraud act offences. There's also the offences of false accounting and false statements by company directors, which are in the 1968 Theft Act. There's a Companies Act fraud offence of fraudulent trading, which is covered. And then interestingly, and I know Alexis, this is of particular relevance to you and many of our listeners that cheating the public revenue, so tax fraud, is covered by the offence as well. So generally speaking, for any of these offences to be made out, the perpetrator would have to have acted dishonestly and intended to cause a gain or a loss as a consequence of their dishonesty. Negligence, recklessness, are generally not sufficient for the criminal fraud threshold to be met. So what types of conduct might trigger these fraud offenses? Well, it will include things like an employee of a company knowingly making false statements in, for example, the company's accounts, in its tax filings, in its sales materials, or in insurance claims or documents it sends to its employees.
Alexis	Thanks Tom, that's a really helpful counter through that. And I know there's been quite a lot of focus on this offence only applying to large companies or organisations. Can you walk us through that and what it means?
Tom	When a year or two years ago, when ECCTA was kind of still a bill in parliament, and then when it first came into force, a lot of the attention it received was around a distinction drawn between large companies, large organisations, and those that weren't large, and what that meant in terms of who would be in scope of the offence. So at a broad level, the failure to prevent fraud offense set out in ECCTA only applies to what are called large companies, large organisations. And large organisations for these purposes are those that meet two or more of the following three criteria. And those criteria are whether that company has 250 or more employees, whether it had a turnover of £36m more in the relevant year of the offending, and if they are a subsidiary of a large organisation. So a small UK subsidiary of a large international group, for example, can be in scope. The distinction here is that the only associated person of a subsidiary like that will be its employees. So the offending can't be committed by an agent, for example, or a reseller or a distributor, it would have to be by an employee of that subsidiary.
Alexis	Thanks Tom. So what about jurisdictional limits then? Does this only apply to companies operating in the UK or with some other link here?

Tom

So the question of jurisdictional limits and extraterritoriality of section 199 of ECCTA is an interesting one. So the new offence is drawn very broadly from a jurisdictional perspective. It applies to what are called relevant organisations and relevant organisations are companies or partnerships established anywhere in the world. So obviously we've just discussed the size restrictions, but from a geographical, jurisdictional perspective, any company anywhere can be a relevant organisation. So there's no requirement for a prosecutor to demonstrate any kind of UK nexus of a company to establish the failure to prevent fraud offence. So that's different, for example, to the bribery act offence of failure to prevent bribery where for an overseas company to be within the scope of the offence, the prosecutor would need to demonstrate that that business carries on a business in the UK. So you can see there's a slight distinction in how broadly the failure to prevent fraud offence is drawn. But there are important jurisdictional limits created by the underlying fraud offences. So as I said, the underlying fraud offences haven't changed in their nature, and one of those must be committed by the associated person. So if a purely overseas fraud offence, a non-UK fraud offence is committed, that won't be sufficient to trigger the failure to prevent offence. Having said that, most of the fraud offences, that I read out before, have fairly broad extraterritorial effect in themselves. In the majority of cases of those fraud offences, UK jurisdiction will be established if what's called a relevant event in relation to the underlying fraud offence took place in the UK, and that can generally entail an act of perpetrating the fraud - so for example, that can involve where the representation was made from, so an employee sat in the UK making a false representation from the UK, or it can entail activities carried out abroad, but where the victims are in the UK. So there's potential quite broad routes to establish UK jurisdiction, English law jurisdiction in these underlying fraud offences. Just as an aside, just for completeness, one of the underlying fraud offences, fraudulent trading, the Companies Act Fraud Offence, doesn't have broad jurisdiction in the same way and only applies to UK companies.

Alexis

So this sounds like it has quite a lot of scope to affect large overseas companies then.

Tom

Yes, it does. So if they're large enough to meet the size thresholds that we talked about before, the failure to prevent fraud offence will apply to them, they will be relevant organisations. Would they require that an associated person of that overseas company commits a UK fraud offence to trigger the failure to prevent offence? So those overseas companies with UK based employees, UK based subsidiaries could conceivably have the necessary touch points to the UK to create a risk. Additionally, if those overseas companies have customers to whom they sell in the UK or if they're seeking investment from UK-based investors, you can see a situation where that creates a risk of potential UK-based victims, again, which might be sufficient to trigger an underlying fraud offence and therefore meet the necessary jurisdictional thresholds.

Alexis

So you mentioned there's a compliance-based defence. How does that work?

Tom

There is, and this is particularly important. So as with the other failure to prevent offences, there's only one defence to this new offence. As I said at the start, this is a strict liability offense, so if the component parts are made out, the offending will be made out subject to the important compliance-based defence. So that defence will be available to a company if it can demonstrate that it had in place reasonable fraud prevention procedures at the time of the relevant conduct.

So what does it mean to have reasonable procedures in place? Well, in many ways, it's similar to what we've seen before in the bribery act, that the test there was adequate procedures. You know, on balance, the tests are probably relatively similar. So companies will be familiar with establishing the types of procedures around bribery that are now foreseen by this defence. Additionally, the UK Home Office has issued guidance for companies on this point around reasonable procedures, which is helpful. The guidance is based around six principles, so it's a principles-based compliance system. It will be familiar to those who've implemented bribery compliance frameworks following similar guidance that was issued in support of the Bribery Act. The six principles around which the guidance is based are as follows: top level commitment, risk assessments, due diligence, proportionate procedures, communication and training and monitoring and review. So it's foreseen that a reasonable compliance - fraud compliance - framework would take into account those principles. Along with obviously the situation of the business in question, its size, its scale, its own risks. There are more specific points that the guidance points to as well. So it looks at how a company might leverage its technology to assist with fraud prevention. So that might, for instance, look at how it can leverage its existing third party due diligence procedures to incorporate fraud risk. It's probably already looking at other risks like bribery, like sanctions. The guidance also looks at how companies might conduct fraud related investigations as part of its procedures and framework. One point I should make is the guidance makes it clear that it's unlikely to be sufficient to rely on the fact that the company has systems in place to deal with financial crime more broadly, and it is now expected to deal with specifically.

Alexis

So when does the new Fairly to Prevent Fraud offence come into force?

Tom Yeah, an important point. So it comes into force on the 1st of September. It's not retroactive, so it will only apply to conduct that occurs after that date. So there's a couple more months almost for companies to prepare.

Alexis And brought me on to my final question. So what should or can companies be doing to prepare?

Tom So if they haven't already started, I think companies should be assessing whether the procedures they have in place currently relating to fraud address these new risks presented by the failure to prevent fraud offence, particularly whether their current frameworks are suitable for addressing a situation where the company may be the perpetrator of the fraud rather than the victim of the fraud. At least it might experience the majority of companies' fraud compliance frameworks that have existed to date very much focus on situations where the company will be the victim of the fraud, for instance, dealing with things like expenses fraud, fraud committed by employees, not looking at the other way round, as in the situation where the company is the perpetrator. So that's one part, perhaps the most important part of this and going back to the six principles we discussed will be the risk assessment. In reality, any other compliance enhancements or changes that a company needs to make will be drawn from the results of the risk assessment process. But those other steps may include implementing a new policy relating to fraud, or at least updating and enhancing existing financial crime policies to more specifically address fraud. They also may include drafting and including in third party contracts, representations and warranties and other protections around fraud in a way that has now become commonplace for bribery, for instance. And I think, Alexis, we may look a little bit more at some of the next steps for companies in our next episode as well.

Alexis Brilliant. Thank you so much, Tom, and to everyone for listening. That's all we've got time for today. We'll be back soon with our final episode in this series when we'll be looking in more detail at some potential future developments in this area, as Tom says. See you soon.

As ever, a big thank you goes to RPC's in-house team for the production, music and sound editing of this episode.

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