

Q&A on the new ‘failure to prevent fraud’ offence

1. Government amendment 84A to the Economic Crime and Corporate Transparency Bill introduces a new ‘failure to prevent fraud’ offence. This implements an important part of the Law Commission’s recommendations on reform to the UK’s corporate liability framework.
2. However, the amendment departs from the Law Commission’s recommendations in an important respect on how failure to prevent offences should be designed – by stipulating that the offence will only apply to “large organisations”. This includes companies who meet two out of the following three criteria:
 - a turnover of more than £36 million;
 - a balance sheet of more than £18 million; and
 - more than 250 employees.

Is the threshold justified?

3. The government has stated that the threshold has been put in place in order “to avoid disproportionate burdens on SMEs and support economic growth,”¹ and to “reduce the compliance burden on smaller organisations, who will have fewer resources to enable them to understand and deliver reasonable fraud prevention procedures.”
4. It is not clear however on what basis this assessment has been made or what the evidence base is to support it. In particular it is not clear why the threshold is necessary given the construction of the offence or why the introduction of the offence would create a disproportionate burden on smaller organisations.
5. The offence already contains a defence for a company to argue that its procedures were reasonable in all the circumstances or that it was not reasonable to expect the body to have any prevention procedures in place. It is open to the government to make clear in guidance issued for the offence what reasonable procedures would be proportionate for SMEs, and in what circumstances it would be reasonable not to have them at all. The government’s impact statement acknowledges that the use of the ‘reasonable’ threshold in itself “has been determined to place a lesser burden on organisations” than the ‘adequate procedures’ defence in the Bribery Act.²
6. Similar arguments about SMEs were raised in relation to the failure to prevent offence (Section 7) in the Bribery Act 2010, including that it would impact on their ability to export. A 2015 government survey of SMEs found however that nine out of

¹<https://www.gov.uk/government/publications/economic-crime-and-corporate-transparency-bill-2022-factsheets/factsheet-failure-to-prevent-fraud-offence>

²https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/114959/6/Impact_Assessment_for_Failure_to_Prevent_Fraud_Home_Office_.pdf

10 SMEs reported that they had no concerns or problems with the Act and 89% felt that the Act had had no impact on their ability to export.³

7. Concerns about the impact on SMEs were raised again when the House of Lords undertook post-legislative scrutiny of the Bribery Act.⁴ The House of Lords concluded that there was no need for any statutory exemption for SMEs from the Act, but that the government should provide better guidance specifically for SMEs about what preventative procedures should consist of.
8. The Law Commission similarly received some submissions arguing that SMEs should be excluded from corporate liability reform on the basis of disproportionate burden but it did not recommend any statutory exemption in formulating the basic principles that failure to prevent offences should follow.⁵
9. Government research on SME adoption of preventative procedures in relation to the Bribery Act found that the average cost for an SME was £2,730,⁶ with medium sized enterprises spending an average of £4,610. If companies have a turnover of between £20-£36 million and average costs are similar for the fraud offence, this is a relatively small amount of money for a corporate to spend to have anti-fraud procedures in place.

Is the threshold set by the government the right one?

10. The government has based the threshold on the Companies Act 2006 definition of Small and Medium Sized Enterprises.
11. Research conducted by the government a decade ago however, suggests that the threshold may be too high. The government's National "*SME fraud segmentation*" found that medium-sized companies with turnovers of between £20 million and £40 million and employees of 100-249 were significantly more likely to experience fraud even than companies over these thresholds.⁷ The likely reason for this is that companies in this category may engage in rapid growth without having the procedures in place to prevent fraud. While it is not clear whether this research distinguished between fraud that was committed by employees for the company's benefit and that committed to its detriment, the procedures to prevent fraud being committed by or against companies of this size are likely to be largely the same.

³https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/440661/insight-into-awareness-and-impact-of-the-bribery-act-2010.pdf

⁴<https://publications.parliament.uk/pa/ld201719/ldselect/ldbriact/303/303.pdf>

⁵https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsou24uy7q/uploads/2022/06/Corporate-Criminal-Liability-Options-Paper_LC.pdf

⁶https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/440661/insight-into-awareness-and-impact-of-the-bribery-act-2010.pdf

⁷https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/118453/sme-fraud-segmentation.pdf

12. This strongly suggests that the government has set the threshold too high in relation to the risk of fraud. If a threshold is maintained, serious consideration should be given to lowering the threshold to include only small enterprises (not medium enterprises). Additionally, it suggests that the government should conduct new research including on SME fraud segmentation in order to understand the risks and impact that this legislation will have on fraud risks across the SME sector.

What are the risks of having a threshold for SMEs?

13. There are a series of risks associated with introducing a threshold for the failure to prevent fraud offence that need serious examination:
- a. Fair application of the rule of law: it is essential for respect for the rule of law that legislation applies equally to all, and that it is as consistent as possible. The introduction of the threshold cuts across the Law Commission's recommendation that failure to prevent offences should be standardised across criminal law as there is no threshold in any other current failure to prevent offence.
 - b. Failure to raise standards across the board: the government acknowledges in its impact assessment that the exclusion of SMEs from the scope of the offence "*will reduce the possible benefits and the potential for culture change.*"⁸ The failure to include SMEs will make it harder to change business culture across the country, given that SMEs account for 99.9% of UK business.⁹
 - c. Failure to encourage the adoption of procedures that would prevent SMEs from being victims of fraud: several bodies from the Metropolitan Police¹⁰ to UK Finance¹¹ have warned that SMEs are particularly vulnerable to being victims of fraud and encouraged them to proactively put in place anti-fraud procedures. Anti-fraud procedures to prevent companies committing fraud are largely similar to those to prevent them committing it or it being committed on their behalf, so the failure to include SMEs in scope is a missed opportunity to help protect the SME sector from fraud more generally.
 - d. Tackling professional enablers: the amendment has been touted as an offence that will address enablers of economic crime. However, many legal and accountancy sectors who are at risk of fraud will fall outside of scope. In the context of the legal sector, it is likely that only around 100 law firms out of the UK's 10,400 law firms are likely to be in scope.¹²

⁸https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/114959/6/Impact_Assessment_for_Failure_to_Prevent_Fraud_Home_Office_.pdf, para 67

⁹<https://www.gov.uk/government/statistics/business-population-estimates-2022/business-population-estimates-for-the-uk-and-regions-2022-statistical-release-html#:~:text=The%20UK%20private%20sector%20comprises,million%20UK%20private%20sector%20businesses>

¹⁰<https://www.met.police.uk/advice/advice-and-information/fa/fraud/business-fraud/how-to-prevent-business-fraud/>

¹¹<https://www.ukfinance.org.uk/press/press-releases/uk-finance-warns-smes-increased-risk-targeted-scams>

¹²<https://www.pirical.com/blog/heres-the-uk-legal-market-in-numbers-infographic>

- e. Increased risk for public procurement: the government has committed to increase procurement with SMEs across the board. The total value of direct public spending with SMEs has nearly doubled since 2016, from £20 billion in 2016 to £38 billion in 2021.¹³ 38% of local government direct spend is with SMEs. As a recent government review found, risks of fraud and corruption in local government are significant.¹⁴ With the Public Sector Fraud Authority estimating that between £33.2 and £58.8 billion is lost to fraud and error annually,¹⁵ ensuring all businesses are subject to the offence would help embed the preventive approach to tackling fraud in public expenditure recommended by the National Audit Office in its recent report.¹⁶
- f. Creating perverse incentives: there is a risk that the exemption could create perverse incentives for corporate behaviour and growth. These incentives could include: SMEs missing out on business opportunities to larger businesses because they are perceived to be more of a fraud risk; medium-sized companies, who from the government's own research are the most high risk of fraud, curtailing corporate growth to avoid regulation in this area; and larger companies setting up new corporate structures to conduct high-risk business, rather than working through subsidiaries. These incentives need full consideration but are not reflected in the impact assessment.

¹³ <https://www.britishchambers.org.uk/news/2022/10/only-one-in-five-pounds-of-direct-government-public-procurement-spending-awarded-to-smes>

¹⁴ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/890748/Fraud_and_corruption_risks_in_local_government_procurement_FINAL.pdf

¹⁵ <https://www.nao.org.uk/wp-content/uploads/2023/03/tackling-fraud-and-corruption-against-government.pdf>

¹⁶ <https://www.nao.org.uk/wp-content/uploads/2023/03/tackling-fraud-and-corruption-against-government.pdf>