ORRICK

ORRICK, HERRINGTON & SUTCLIFFE (EUROPE) LLP
107 CHEAPSIDE
LONDON EC2V 6DN
DX 557 LONDON/CITY

tel +44 (0) 20 7862 4600
fax +44 (0) 20 7862 4800

WWW.ORRICK.COM

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Our ref: SW

Anna Colban
Secretary to the Board
Accountancy and Actuarial Discipline Board
Aldwych House
71-91 Aldwych
London
WC2B 4HN

Simon Willis
+44 20 7862 4682
swillis@orrick.com

Dear Ms. Colban,

Re: **AADB Consultation Paper: Sanctions Guidance to Tribunals, April 2012 (the "Consultation Paper")**

Thank you for the opportunity to respond to the Consultation Paper.

Orrick has a team of lawyers with extensive experience of representing accounting firms in disciplinary matters. Our lawyers have acted in a number of significant cases under the current AADB Scheme and its predecessor, the JDS, including: Barings, Mayflower and Equitable Life.

Our perspective is therefore as advisor to Member Firms and Members who are the subject of disciplinary investigations and proceedings. We hope that the enclosed response will prove helpful.

Yours sincerely,

pp. **Simon Willis**

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1. DO YOU AGREE WITH THE BOARD'S OBJECTIVES AND APPROACH TO SANCTIONS GUIDANCE?

Objectives

1.1 We agree that it may be desirable for there to be some indicative sanctions guidance available to Tribunals to promote consistency and transparency in accountants' disciplinary proceedings.

1.2 The Board refers with approval to the following passage from the judgment in *R (on the application of Coke-Wallis) v The Institute of Chartered Accountants in England and Wallis*[1] ("*Coke-Wallis*"):

> *"The primary purpose of professional disciplinary proceedings is not to punish, but to protect the public, to maintain public confidence in the integrity of the profession, and to uphold proper standards of behaviour: see e.g. Bolton v Law Society [1994] 1 WLR 512, 518, per Sir Thomas Bingham MR; Gupta v General Medical Council [2002] 1 WLR 1691, para 21, per Lord Rodger."*

1.3 In addition to the purpose set out in *Coke-Wallis*, the Board considers that sanctions must "*encourage high standards of conduct amongst Members and Member Firms*"[2] and should therefore have a "*credible deterrent effect*"[3], deterrence being one of the principles of a regulatory sanctioning regime identified in the Macrory report. Deterrence is also one of the three principles that it is proposed should apply to all Tribunal decisions on sanctions along with proportionality and the need for public confidence that the AADB is taking firm action. We agree with this.

Approach

1.4 We do not, however, agree that Member Firms currently lack an effective deterrent to misconduct or are insufficiently encouraged to promote and maintain the highest standards of conduct among their professional staff.

1.5 Professional firms trade on their reputation for excellence. In our experience, Member Firms devote considerable resources to encouraging and maintaining high quality and standards of conduct throughout their practice. They do so not only because they are committed professionals but also because it is good for business. The damage to a Member Firm's professional reputation (and to its ability to win business) caused by being publicly criticized for having fallen short of a reasonable standard is already a very effective deterrent to misconduct. The reputational damage caused by being found to have failed to have reached the standards reasonably to be expected is of a much

[1] [2011] UKSC 1
[2] Consultation Paper para 3.5
[3] Consultation Paper para 3.7

higher order of magnitude than the short term commercial gain (if any) which might be imagined to accrue to a Member Firm from failing to encourage high standards of conduct.

1.6 Conversely, it cannot sensibly be argued that Member Firms are somehow encouraged or motivated to risk misconduct by an absence of higher financial sanctions in the disciplinary regime. Even if the risk of a fine imposed by a Tribunal is a motivation for Member Firms to prevent misconduct and achieve high standards, and therefore serves as some deterrent, in our experience it is neither the only nor the most important motivation. Misconduct may expose the Member Firm to civil and regulatory liability and a failure to encourage and achieve high standards may lead also to a Member Firm falling foul of institutional controls such as audit inspections.

1.7 The position of individual Members is similar. Simply being the subject of disciplinary investigation or complaint (or civil or regulatory proceedings) is stigmatizing and damaging to the individual's career, as well as personally traumatic, whatever the outcome. If public findings of misconduct are made the damage is all the greater and, we would suggest, it is not necessary to impose any higher individual sanctions than have historically been ordered to achieve effective deterrence for individuals.

Fines

1.8 The Consultation Paper assumes that a fine which does not have a material adverse effect on the profitability of a Member Firm cannot be effective as a deterrent. That is in our view over simplistic. The real deterrent value of a fine is that it is stigmatizing for the Member or Member Firm regardless of the relationship to financial means. The role of a monetary sanction is as a means of signalling the degree of disapproval of the relevant conduct. To fulfil that stigmatizing purpose, fines need to be at a level which is significant i.e. more than merely trivial. Past fines have been at a far from trivial level. Fines should also be set by reference to a defined range so that the position of the fine within that range may serve to indicate the degree of seriousness of the misconduct and the Tribunal's disapproval of it. It is not necessary to satisfy this stigmatizing purpose that the fine causes a material financial impact relative to the Member Firm's turnover and profitability or a Member's individual income (i.e. that it has a punitive financial impact).

1.9 In our opinion increasing fines to the point where they are "*high enough for the impact of the fine to be felt by the Member or Member Firm concerned*"[4] will not create any stronger incentive than already exists for both Member Firms and Members to achieve the highest standards in practice or enhance public confidence in the profession.

1.10 The new scale of fines proposed exceeds what is reasonably required by way of deterrence. It imports into the professional disciplinary process the concept of

[4] Draft Guidance para 29

punishment, which is directly contrary to the Board's express approval of the judgment in Coke-Wallis. Furthermore, imposing fines at a level designed to have a material adverse financial impact on Member Firms has a number of disadvantages which may undermine the objectives of the scheme and the public's confidence in it, which we discuss in our answer to question 11 below.

Credibility

1.11 The choice of the word "credible" rather than, say, "effective", suggests that the Board has concluded that, regardless of whether higher fines are *in fact* necessary for reasons of deterrence, they should nevertheless be introduced because (whatever the reality) large monetary sanctions are required to create the *perception* of effective deterrence. The guidance on fines reflects this thinking at paragraph 29:

> *"In order to have* ***and to be seen to have*** *a meaningful deterrent effect, the Fine imposed will normally be high enough for the impact of the fine to be felt by the Member or Member Firm concerned." (our emphasis).*

1.12 We disagree that there is any reason to suppose that unless fines are set at a level which has a material financial impact, the disciplinary process will be perceived to be ineffective as a deterrent to Members or Member Firms in the considered opinion of any reasonable person. Even if that is not the case, sanctions policy should not be dictated by what certain pockets of public opinion might from time to time consider to be required but by what is effective in fact, taking into account the objectives of the disciplinary process.

1.13 The key to the perception of the disciplinary process as an effective deterrent is the quality and efficiency of the investigations and by ensuring that complaints are only brought where it has been concluded, based on appropriate, independent expert evidence, that there is a real prospect of success. If there is a credibility problem with the disciplinary process then the cause is more likely to be the withdrawal or dismissal of complaints that should never have been made, as happened in cases such as Equitable Life and Mayflower, than the size of the fines that have been imposed to date.

2. DO YOU AGREE THAT TRIBUNALS NEED A CLEAR FRAMEWORK FOR SANCTIONS WHICH REFLECTS THE NATURE OF ITS CASES AND THE WIDER CONTEXT IN WHICH THE ACCOUNTANCY PROFESSION OPERATES TODAY?

2.1 The section in the Consultation Paper on "*Determining the appropriate level for a Fine*" contains a number of statements about changes in the profession which we assume are part of the wider context which has been taken into account in making these proposals.

2.2 Those changes are that :

(a) The size and scope of the work of Member Firms has increased; and

(b) market concentration has increased with the result that a smaller number of firms conduct a larger number of audits. The top four firms perform 99% of the audits of the FTSE 100 companies.

2.3 Because of the size and scale of the large accounting firms it is said that misconduct by Member Firms is all the more serious and potentially damaging to the public interest. Furthermore, the increase in the revenue generated by Member Firms, the fees received by the large firms for audit and non-audit work, and the size and global nature of the businesses on which they report, are indicators of a significant shift in the wider context in which fines are now imposed.

2.4 These factors are said to suggest that fines at historic levels would not be proportionate to the current environment in which Member Firms operate, would not be adequate to incentivize the right kind of behaviour and would fail to meet the need of a credible deterrent.

2.5 This consideration of the wider context leads to the proposal that fines should be set by reference to "revenue" or, where revenue is not an appropriate indicator of financial means, by considering alternative "indicators of size and financial means" including "market share", profits per partner, the number of audit and non audit clients, and the size of those clients, or the number of principles, partners and registered individuals.[5] It is further proposed that in considering turnover, the Tribunal should include all entities subject to control by the same management team and with the same beneficial ownership.

2.6 For the reasons already explained, we do not agree that there is a lack of a credible deterrent or that fines set at a percentage of turnover (however defined) will have any material impact on the level of deterrence or incentive that already exists. It is true that there have been changes in "*the structure of the accounting profession, in the scope of the work it undertakes, in the remuneration paid to it and in the responsibilities and risks attached to the activities on which it reports*"[6]. It does not follow that there has also been a change, still less a decline in the extent to which firms are motivated to promote and maintain the highest standards and there is no evidence that this is the case. In fact, we suggest the opposite is likely to be true.

2.7 It is not clear whether, considerations of deterrence aside, it is suggested that the "*wider context in which the accountancy profession operates today*" should have any other influence on determining disciplinary sanctions. We are strongly of the view that if it is to maintain independence and credibility with the public and Member Firms alike, great care should be taken to separate the disciplinary process from the short term ebb and flow of political or policy debates concerning the profession that happen to be taking place in the

[5] Draft Guidance para 33.
[6] Draft Guidance para 3

"*wider context*" at any particular time. The sanctions to be applied in a particular case should be indifferent to the pressures of the times, set solely by reference to the severity of misconduct which has been found by the Tribunal (which has considered all the evidence) to have occurred. Disciplinary fines should not be a public opinion tax. This is particularly the case if the misconduct in question occurred several years previously (and it has been a feature of the disciplinary process that cases can take many years to come to a conclusion).

3. DO YOU AGREE THAT THE SANCTIONS IMPOSED BY TRIBUNALS SHOULD ACT AS A CREDIBLE DETERRENT AND BE PROPORTIONATE TO THE SERIOUSNESS OF THE MISCONDUCT AND TO ALL THE CIRCUMSTANCES OF THE CASE, INCLUDING THE FINANCIAL RESOURCES OF MEMBERS AND THE SIZE AND FINANCIAL RESOURCES OF MEMBER FIRMS?

3.1 As we say in answer to question 1, in our opinion, the purpose of a disciplinary fine is to signal disapproval of the Member Firm's conduct. To fulfil that stigmatizing purpose, fines need to be at a level which is significant i.e. more than merely trivial. It is not, however, necessary that the fine causes a material financial impact relative to the Member Firm's turnover and profitability (i.e. that it has a punitive financial impact).

3.2 Nor, in our opinion, is it desirable that the fine should be calculated by reference to the particular turnover (or income) of a defendant. The Tribunal in the JP Morgan case rejected the argument put forward on behalf of the Executive Counsel that the fine imposed should bear some relationship to turnover or net profit. The Tribunal referred with approval to the principles governing the power of a Court to levy a fine in a regulatory context stated in *R v Howe & Co (Engineers) Ltd*[7] cited by Lord Phillips LCJ in *R v Balfour Beatty Rail Infrastructure Services Ltd*[8]. In particular the Tribunal said the following :

> *"Allowing for the fact that the statutory rules in those cases related to the preservation of the physical safety of the public (and not as in this case the financial integrity of JPMSL's client money), the principles have considerable relevance. We would summarise the relevant principles and their application in this case as follows:.....*
>
> *(3)* ***It is not possible to assert that a fine should stand in any specific relationship with a turnover or net profit of a defendant. Each case must be dealt with according to its own circumstances.*** *This was the thrust of Mr Dutton's submissions in opposition to those of Mr Browne-Wilkinson, and we agree with it"*

3.3 We respectfully agree that with the Tribunal's judgment that fines in a disciplinary context should not stand in any specific relationship to turnover (or, in the case of a Member,

[7] [1999] Cr App Rep (S) 37
[8] [2006] EWCA Crim 1586

individual income). For fines to be fair and proportionate to the circumstances of each case they cannot be pegged to a crude mathematical calculation which applies regardless of the underlying facts. Financial resources may be a mitigating factor but they should not, in our view, be relevant to the range or starting point of monetary sanctions.

3.4 A related point is that there is a difference between professional disciplinary proceedings against secondary actors (those such as auditors who might fall short in their analysis of the conduct of or information produced by a client) and the enforcement actions taken by other regulators against primary actors (the client who is primarily responsible for creating the problem in the first place). To quote the Tribunal in the JP Morgan case:

> *"Quite different considerations apply to the primary actor and its regulator from those applying to the auditor and reporting accountant. The suggestion that the penalty on PwC should bear the same proportion to its profits as the penalty on JPMSL bore to its profits seems to us to be irrational."*

3.5 The level of fines which are imposed in other regulatory contexts on primary actors, for example by the FSA, are not helpful comparables when considering professional misconduct and fines in the context of a professional disciplinary process. The latter is predominantly concerned with errors of judgment rather than deliberate or reckless misconduct for reasons of personal or corporate gain.

3.6 If, as we suggest, the purpose of a fine is to signal disapproval, a better way of achieving this would be by identifying a range of fines by reference to indicative amounts and selecting a value within that range commensurate with the relative seriousness of the case. This would be a far more effective way of conveying the seriousness of the misconduct and the degree of disapproval than fines whose value simply depends on the turnover of the particular defendant. Otherwise, very serious misconduct by a smaller firm could attract a much lower fine than relatively minor misconduct by a larger one. That would seem to us to defeat the primary purpose of fines in a disciplinary context and risk bringing the process into disrepute.

3.7 We agree that the historic level of fines may now be too low to meet the objective of being sufficiently "significant" in every case to signal disapproval but this was recognised and adequately dealt with in the JP Morgan case. We also agree that some guidance as to the range of fines may be appropriate to ensure a degree of consistency so that differences in the seriousness of misconduct can be reflected in differences in the level of fines imposed.

3.8 The Tribunal in the JP Morgan case found that a starting point of £2m for fines would be appropriate to meet the expectation of the public that the penalty should be substantial with an upper limit of £5m being sufficient for all but the most exceptional cases. In the Tribunal's judgment, that was a sufficiently substantial increase taking into account all the policy objectives of sanctioning set out in the Macrory review.

3.9 We consider the approach of the Tribunal in the JP Morgan case to be correct in as much as it focused on a defined range of fines as a means of signalling disapproval and rejected the principle that fines should stand in any specific relationship with a turnover or net profit.

3.10 The suggestion that turnover might be calculated by reference to entities under the same control or beneficial ownership is analogous to the sanctions regime operated by the European Commission to determine fines for anti-competitive behaviour. Such a regime is clearly focussed on punishment. The importation of similar principles into a professional disciplinary process would wrongly introduce an additional punitive element to sanction, contrary to the primary purpose expressed in *Coke-Wallis*.

4. HAVE WE INCLUDED THE SORTS OF FACTORS IN THE SANCTIONS GUIDANCE THAT YOU WOULD EXPECT TO SEE TAKEN INTO ACCOUNT BY TRIBUNALS?

Aims and Objectives

4.1 One of the aims and objectives of the Disciplinary Scheme sanctions is said to be to *"aim to remedy the harm caused by misconduct"*[9]. It is unclear how sanctions for professional misconduct can achieve that objective given the lack of any jurisdiction to compensate those affected. We suggest that bullet is explained further or deleted. Without more, it suggests that a disciplinary Tribunal will now be concerned to establish causation and loss, as well as misconduct, trespassing on the jurisdiction of the civil courts.

Factors to be taken into Account

4.2 The factors to be taken into account can be categorized in one of two ways: factors relevant to the severity or seriousness of the act of misconduct itself and factors relevant to the consequences of the misconduct.

4.3 For example, the following factors fall into the second "consequences" category:

(a) the misconduct involved or caused or put at risk the loss of significant sums of money;

(b) the scope for any potential financial crime (such as fraud) to be facilitated, occasioned or otherwise occur as a result of the misconduct;

(c) if the misconduct adversely affected, or potentially adversely affected, a significant number of people in the United Kingdom.

[9] Draft Guidance para 10

4.4 Professional disciplinary sanctions do not have as their objective punishment, retribution or compensation for the harm caused by the misconduct. On one view, the consequences of the misconduct (or the size and importance of the engagement) should therefore have no bearing on the level of sanction for the misconduct. The same fault should receive the same sanction regardless of the consequences of that fault (unless of course the fact that the professional has foreseen those consequences is an aggravating factor in assessing the seriousness of the misconduct itself). If the same fault is punished differently according to the unintended consequences which arise it sends the message that the profession is not as concerned with breaches of professional standards where there is less at stake.

4.5 However, the principle that the severity of the consequences of the misconduct should be taken into account in determining the sanction to be applied by the Tribunal is one which has been part of the disciplinary process since the days of the JDS. We do not therefore take issue with the proposal that a greater sanction may be imposed in cases where the misconduct has adverse unintended consequences. Public confidence may well be damaged were this principle now to be reversed. Provided fines are calibrated at the stigmatising level rather than the punitive levels envisaged by the draft guidance, we suggest that any unfairness in adjusting sanctions for unintended consequences would arguably be justifiable, taking into account the need to maintain public confidence in the process.

4.6 That part of the guidance which is concerned with assessing the nature and seriousness of the misconduct and the appropriateness of the available sanctions is in our view unnecessarily complicated and repetitive. The combination of sanctions applied should collectively reflect the nature and seriousness of the misconduct to an appropriate degree. We suggest that the guidance be structured in a way which encourages that pattern of analysis:

(a) Before describing each alternative sanction, the guidance should list all those matters to be considered when assessing the nature and seriousness of the misconduct (currently paragraph 31); and

(b) each alternative sanction might then be described with guidance as to the circumstances in which it might be appropriate to apply that sanction whether alone or in conjunction with others.

Intention and Recklessness

4.7 The guidance requires the Tribunal to consider whether there has been intent or recklessness and offers a list of "factors tending to show" the necessary state of mind. If a Member of Member Firm is to be sanctioned on the basis that (s)he or it has deliberately or recklessly committed an act of misconduct then intention or recklessness should be proven to the satisfaction of the Tribunal. Particularly cogent evidence should

be required for such a serious finding. In our view it is unhelpful to give partial guidance as to when findings of intention or recklessness should be made. Either the guidance needs to deal comprehensively with the relevant legal tests or stay silent and leave the Tribunal to determine whether there is sufficient evidence to make such a serious finding by reference to the general law.

Adjustment for Deterrence

4.8 The "Adjustment for Deterrence" is in our view unnecessary and inappropriate. The existing disciplinary sanctions and other potential consequences of misconduct provide effective deterrence. Consistent with the fact that this is not a process of punishment, the level of the fine or other penalty should be determined solely by reference to factors relating to the particular Member or Member Firm and not by reference to extraneous considerations. It should not be the function of disciplinary sanctions to "send a message" or "make an example" of a particular firm if that means increasing the sanction beyond that which would otherwise have been proportionate. A "heads on spikes" approach to disciplinary sanction is not, long term, going to improve the reputation of the profession or the disciplinary process.

4.9 Apart from disagreeing with the principle that Tribunals should be encouraged to "make an example" of a particular Member or Member Firm we would also challenge the assumption that the fact that a Member or Member Firm has been found guilty of misconduct is necessarily indicative of a lack of appropriate standards throughout the profession. Nor does it follow from the fact that a Member or Member Firm has repeated another's mistake that standards are in need of improvement generally or have not been improved. It is over simplistic to assume from the tiny proportion of professionals whose work comes to be scrutinized by the disciplinary process that they are "all at it" and that it is therefore necessary to make an example of a particular Member or Member Firm based on that assumption.

Discount for Admissions

4.10 The imposition of fines of the magnitude proposed creates the problem that those fines are so large relative to the costs of the disciplinary proceedings that the risk of liability for the costs of the proceedings is not as much of an incentive to settle as it is under the current regime. The Discount for Admissions is presumably designed to redress that imbalance and encourage Member Firms to settle by offering the possibility of a fixed % reduction of an extremely large fine where Formal Complaints are admitted. (Where some but not all the heads of the Formal Complaint are admitted, discounts may be negotiated or determined by the Tribunal).

4.11 Whatever the range of sanctions, the extent, significance and timing of admissions should always be a mitigating factor in determining the sanction to be imposed. The problem with the current proposals is that they are too prescriptive and inflexible. The

opportunity to admit fault is offered only on a "take it or leave it" basis which demands that Formal Complaints (or heads of Complaint) are admitted *as stated* by certain points in the process.

4.12 There are examples in past cases of heads of Complaint being modified or abandoned. If, following such modification or abandonment, the Member or Member Firm feels able to admit the Formal Complaint in whole or on part, then it is unfair to deny (or reduce the level of) a discount simply because the Formal Complaint was originally misconceived, overstated or poorly explained. Giving a fixed discount solely by reference to procedural stages without taking account of the conduct of the parties is too simplistic. Professional disciplinary proceedings are not debt claims and the principle of a fixed discount for early payment, however efficient it appears, should not deprive the defendant of credit for admitting a Formal Complaint in whole or in part in circumstances where it could not reasonably be expected to have done so earlier in the process.

4.13 Discounts should be determined on a case by case basis taking into account the extent, significance and timing of admissions. In the case of timing, the level of discount should be determined by reference to the time which has elapsed between the first date in the proceedings when the defendant had all the necessary information and the date of the admission. The guidance should not link the credit to be given for admissions solely to the procedural timetable.

4.14 The link to procedural stages that has been proposed in the Draft Guidance seems in any event to draw arbitrary distinctions. Stage (2) does not seem to us to be sufficiently distinct from Stage (1) to justify a different discount. A Member or Member Firm cannot reasonably be penalized for wanting to discuss draft Complaints or their representations in respect thereof before admitting them. All that reducing the discount available in Stage (2) is likely to achieve is to encourage Members and Member Firms to accept draft Complaints before discussing them fully with the AADB. That does not strike us as a desirable or reasonable objective to promote. The duration of Stage (1) is in any event too uncertain. It is not going to be possible for the Member or Member Firm to determine when the AADB has had "a reasonable opportunity to consider its representations".

4.15 There are potentially significant disadvantages in creating a disciplinary system that imposes very high minimum fines and then restricts discounts to those who settle early rather than defend Complaints. Those disadvantages are considered in our answer to question 11 below.

5. ARE THERE ANY FACTORS YOU BELIEVE TRIBUNALS SHOULD TAKE INTO ACCOUNT WHEN DECIDING SANCTION THAT WE HAVE OVERLOOKED?

5.1 The Consultation Paper suggests that fines for Member Firms are a reflection of the fact that the "Member Firm has a responsibility for the conduct of individuals doing work on its behalf, for ensuring that effective and appropriate operating and risk management

procedures are in place and are adhered to and has overall responsibility and oversight of individual transactions"[10]

5.2 While the "degree of responsibility is important when deciding sanction"[11], the current proposals suggest that fines may be imposed on Member Firms where there is no suggestion of weakness in Member Firms' procedures or in the management systems or internal controls of that firm[12]. Where such weakness has been identified it does not appear to be contemplated that the Tribunal should also be satisfied that the Member Firm acted unreasonably in failing to identify and address the weakness before imposing a fine. In short, Member Firms' liability is strict and fines may be imposed in circumstances where the Member Firm is not at fault (other than vicariously).

5.3 We do not disagree with the principle that the ability to issue a sanction to and in the name of the Member Firm, as well as to individuals, may serve to increase deterrence and encourage good practice. In any event, that principle is already enshrined in the Scheme at para 4(8):

> *"A Member Firm shall not avoid liability to investigation and disciplinary proceedings under this Scheme by reason of having established and operated appropriate working practices and procedures, if its conduct (by reason of the conduct of any partner, director or employee acting with actual or ostensible authority) may constitute an act of misconduct."*

5.4 However, the fact that no fault is required on the part of the Member Firm as a prerequisite to the imposition of a fine is another factor which should be taken into account when considering the reasonableness of the proposals. The higher the starting point of the fine, the less reasonable it is to impose it without requiring any finding of fault.

5.5 Whatever the range of fines recommended, we suggest that the Tribunal be directed by the guidance specifically to consider whether the Member Firm has established and operated appropriate working practices *and* been reasonably diligent in seeking to promote and maintain the highest standards of conduct among their professional staff. If it has and is therefore culpable only in the vicarious sense, there should be some recognition of that fact in the setting of the sanction.

5.6 Mitigating a Member Firm's strict liability in this way is not only fairer, it also encourages the right behaviours on the part of Member Firms. Failing to give credit for good practice is not good for public confidence in that it creates a misleading impression of the level of culpability of the Member Firms themselves.

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[10] Consultation Paper para 4.19
[11] Draft Guidance para 15
[12] This follows from the descriptions of the level 1 and level 2 fines at 4.17 of the Consultation Paper

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6. DO YOU AGREE THAT THERE NEEDS TO BE AN ADJUSTMENT IN THE LEVEL OF FINES IMPOSED IN AADB CASES?

6.1 As explained above, we agree that the historic range of fines is now probably too low to meet the objective of being sufficiently "significant" in every case as was recognised and remedied in the JP Morgan case.

7. IF SO, WHAT ADJUSTMENT DO YOU CONSIDER TO BE APPROPRIATE?

7.1 The range suggested in the JP Morgan case is in our view of the right order of magnitude to meet the objective of being significant enough to signal an appropriate level of disapproval in each case. The Tribunal itself allowed for higher fines in exceptional cases:

> *"We doubt whether such aggravating factors should take the penalty beyond the sum of £5 million, but we do not rule out exceptional cases where such a response is required"*

7.2 Given the huge variety in subject matter of the cases which reach the Tribunal, we do not consider that it would be helpful to break down the range into levels as illustrated in the Consultation Paper. That approach seems to us to be overly prescriptive given the number of case specific factors to be involved in any particular complaint.

8. WHAT IS YOUR VIEW OF THE ALTERNATIVE MECHANISMS PROPOSED FOR CALCULATING FINES?

See above.

9. WHAT LEVEL OF TURNOVER / INCOME DO YOU CONSIDER WOULD BE APPROPRIATE IN RESPECT OF EACH MECHANISM?

See above.

10. DO YOU AGREE THAT TRIBUNALS SHOULD NOT TAKE ACCOUNT OF THE COSTS THAT IT IS CONSIDERING AWARDING AGAINST A MEMBER OR MEMBER FIRM WHEN DETERMINING THE APPROPRIATE LEVEL FOR A FINE?

We agree that costs awards and sanctions should be considered separately.

11. DO YOU HAVE ANY OTHER COMMENTS ABOUT THE PROPOSED STRUCTURE OR CONTENT OF THE SANCTIONS GUIDANCE?

11.1 For the reasons explained we are not persuaded that fines at the level proposed will serve to increase deterrence or are necessary for any other legitimate objective of the

professional disciplinary process. As well as a lack of any advantage there are some potentially serious disadvantages to the proposals.

Fairness

11.2 Fairness is not simply a concern of those who are likely to be the subject of sanctions. An enforcement regime which is considered to be both unfair and arbitrary will quickly lose the respect and confidence of the profession. This will discourage the co-operative and constructive dialogue between the Member Firms and the Board which is the key to its success. Public confidence is best served by a disciplinary regime that is perceived to be fair and even handed and which is respected by the profession. Such a regime will encourage a diligent and cooperative approach to improving standards and implementing appropriate corrective measures in response to Tribunal findings and sanctions. There are a number of features of the proposed guidance which, in our view, go beyond what is reasonably required to meet the objectives of the disciplinary process and which are prejudicial to the integrity and reputation of the process.

(a) Sanctions should be limited to what is necessary to achieve the objectives of the professional disciplinary process. In our view, the proposed fines go beyond what is necessary and are therefore only justifiable as punishment, which is not a legitimate objective of professional disciplinary sanctions.

(b) The level of the fine or other penalty should be determined solely by reference to factors relating to the particular Member or Member Firm and not by reference to extraneous considerations. The guidance indicates (see in particular the Adjustment for Deterrence) that sanctions may be increased beyond the level at which they would otherwise be set to send a message or making an example of a particular Member or Member Firm.

(c) The more severe the sanction the less the justification for imposing it without requiring some degree of fault. Imposing fines at current levels on Member Firms purely on the basis of vicarious liability may arguably be justifiable. That argument loses its force if the fines are to be set at the much higher levels proposed.

Settlement

11.3 It does not serve the interests of the profession for legitimate debate on issues of professional conduct to be discouraged or stifled by the threat of severe fines and the offer of discounts for early settlement, particularly when the level of those discounts is linked simply to the timing of the admission with little or no account to be taken of the conduct of the proceedings. Financial pressure to settle is not necessarily a good thing if that pressure means firms are giving up on the defence of Complaints to which they believe they have a credible defence, purely on the basis of "risk assessment". Care

needs to be taken not to reach a situation where the disciplinary process is extorting admissions through the imposition of excessive financial risk. Such a dynamic would do nothing to promote real reform in response to accepted shortcomings, or to protect the public, and risks bringing the profession and the disciplinary process into disrepute.

11.4 Pressure to settle caused by the risk of large fines for Member Firms may have a prejudicial effect on individual respondents to Complaints. Encouraging a Member Firm to settle by creating the risk of a huge fine and offering a discount for early admission may place individual Members, whose reputation is at stake, in a position where their interest in clearing their name is at odds with the Member Firms interest in mitigating its financial risk.

Encouraging High Standards in Member Firms

11.5 The proposed guidance is premised on the theory that to be sufficiently incentivised to achieve the highest standards (and eliminate misconduct) Member Firms require the threat of a large minimum fine.

11.6 Large minimum fines for Member Firms which are imposed where misconduct is found no matter how minor or isolated in nature or how diligent the Member Firm has been may, however, have the opposite of a deterrent effect. As the Consultation Paper recognizes sanctions are a fact of life for regulated professions – no firm can eliminate completely the possibility of human error in each and every member of its staff. If, however, the level of fine is subject to a large minimum no matter how diligent the Member Firm has been in seeking to control risk and quality that could have an adverse impact on the amount of resource a particular firm decides to commit to compliance and risk management functions.

11.7 High fines coupled with the proposed settlement process may also act as a disincentive to improve, for the reasons explained in 11.3 above.

Encouraging High Standards in Members

11.8 A shift in focus to headline grabbing fines for Member Firms is a shift in focus away from the individual professionals. Fines for Member Firms which dwarf the significance of all else may undermine individual ethical incentives rather than encouraging individual accountability and responsibility which is the key element in the maintenance of high standards for any profession. Maintaining professional standards is the primarily the responsibility of the individual professional. An over-emphasis on Member Firms may detract from the individual professional's sense of personal responsibility to the detriment of the profession and the public's confidence in it.

Competition

11.9 No Member Firm, no matter how diligent nor how high its standards, can eliminate the risk that one of its professional staff will make an error of judgement on an issue of importance. If Member Firms are liable to huge fines, whatever their level of culpability, the relatively small audit fees may not be considered to be worth that risk for those smaller firms looking to compete with the larger firms for the bigger and more complex audits. Member Firm fines at levels suggested may therefore discourage firms from competing for large and complex audits (such as the FTSE 100). Conversely larger firms may be discouraged from undertaking lower value work for smaller audit clients.

12. CONCLUSIONS

12.1 The key to effective deterrence is to maximise the success rate for disciplinary complaints. The focus should be on the quality of the process and ensuring that those cases where complaints are abandoned or dismissed are kept to a minimum. For example, we suggest that the following should be objectives in every case.

(a) The process is conducted as quickly and efficiently as possible to avoid unnecessary prejudice to Members and Member Firms by having investigations or complaints outstanding for longer than is necessary and to ensure that the evidence is as fresh as it can be.

(b) There is a constructive dialogue with the Member Firm involved about the scope and timing of the investigation.

(c) Investigations are focused and proportionate, reasonable time is given for the production of documents and reasonable notice given for interviews with witnesses.

(d) Expert advice is taken before complaints are laid, preferably from an expert who was not involved in the investigation.

(e) When selecting experts care is taken to ensure they have expertise in any specialist areas of practice.

(f) Complaints are focused on the crux of the matter - the serious issues which engage the public interest - rather than adopting an exhaustive approach of including every possible failure to meet a reasonable standard no matter how trivial.

12.2 Insofar as deterrence is concerned the proposed fines are, in our opinion, a solution to a problem which does not exist. Fines at the proposed levels are justifiable only on the basis of punishment and not as a means to achieve any of the identified objectives of the disciplinary process.

ORRICK

12.3 If we can provide any further assistance in relation to matters raised in this response, please let us know.

Orrick Herrington & Sutcliffe (Europe) LLP

11 JULY 2012