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Our reference
JJR

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Dear Madam

FRC Consultation Paper, Sanctions Guidance to Tribunals

We set out below our views on the questions raised by the consultation paper concerning the changes proposed to the AADB sanctions regime. As you are aware, the accountants disputes team at Taylor Wessing has extensive experience acting for respondent accountants in disciplinary proceedings. Members of our team acted for Cooper & Lybrand in its defence of the Barings JDS and for Ernst & Young in its defence of the Equitable Life JDS enquiry. More recently members of our team acted for PwC in its defence of the AIDB enquiry into Mayflower. We presently act for respondents in the AADB investigations into members' conduct in relation to Aero Inventory, Tanfield and Cattles.

We propose in this letter to deal first with the principal policy issues raised by the Board's paper and then to address briefly the questions posed in the paper insofar as they are not dealt with in our opening remarks.

The Sanctions Regime

One of the strengths of the AADB regime is that the final determination as to whether there has been misconduct, and as to the sanction to be applied, is made by a genuinely independent tribunal.

It is implicit in the consultation paper that the Board considers that past tribunals have fallen into error when setting sanctions and that tribunals need to hand down *"sanctions that are and are seen to be relevant to the current times".*

It is equally clear from the Board's suggestion that sanctions be fixed by reference to the turnover of member firms that the Board considers tribunals have in the past have set sanctions at much too low a level. It is worth considering why there should be such a gulf between the Board's perception and the decisions reached by a succession of differently constituted, independent tribunals.

The tribunals who have sat upon JDS and AIDB/AADB matters have been faced, in the main, by claims relating to the audit process and, in particular, allegations that there have been

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inadvertent defects in the conduct of the audit of the financial statements of particular companies.

The tribunals have never dealt with cases in which a member firm has deliberately adopted a defective (presumably easier) audit methodology or in which a firm has colluded with dishonest management. Rather the tribunals have had to adjudicate upon the behaviour of professionals who were trying to do the job properly but may have been guilty of inadvertent errors.

Faced with such cases, the tribunals have imposed fines, in the main, of less than £1m. Such fines reflect their judgement as to the seriousness of the error in the context of all the facts. It was open to the tribunal on each occasion to award unlimited fines and to set them at a much higher level if to do so would usefully have deterred such behaviour in the future. They have not done so because, we presume, they recognised that such a penal deterrent factor was not appropriate in the circumstances of the case before them. That is because the misconduct did not in fact reflect an institutional lack of care but rather the (relatively rare but on occasion inevitable) error which occurs in any complex process from time to time.

It is apparent from the consultation paper that the Board has decided (subject to this consultation) that the sanctions regime should be built around the need to deter firms from cutting corners or engaging in dishonest behaviour. As such the suggested changes in the sanctions regime appear to us to be a solution to a problem which does not exist.

The proposed changes

The sanctions paper sets out, at paragraph 3.3, the six factors which the McRory report felt were important in any regulatory sanctioning regime. We do not disagree with the importance of any of those factors. It will be noted that factor 4 states that any sanction should be "*proportionate to the nature of the offence and the harm caused*".

From these factors the Board derives four objectives, as set out at paragraph 3.5 (being to protect the public from misconduct, to maintain and promote public confidence in the accounting profession, to uphold standards and to encourage high standards of conduct). Again these appear to us to be appropriate objectives.

From those objectives the Board derives a policy to secure *"the imposition of proportional sanctions that will have an appropriate and credible deterrent effect and will bolster public and market confidence in the accountancy profession and the disciplinary regime. Sanctions need to have an appropriate impact on those on whom they are imposed, if they are to act as a credible deterrent to future misconduct".*

To achieve this (paragraph 3.17) sanctions must be set by reference to the financial resources of the member firms and (Appendix A, paragraph 29) "*to have a meaningful deterrent effect, the Fine imposed will normally need to be high enough for the impact of a Fine to be felt by the Member or Member Firm concerned*". This apparently requires that the "*starting point*" will not usually be lower than a percentage of the member firm's annual group turnover. The percentage is not stated but we imagine this can only mean that any finding of misconduct by an employee of a Big 4 firm must, at least as a starting point, result in a fine of several million pounds. The reasoning would appear to be that only fines at such a level would get the attention of the larger firms. This reasoning seems to be to us defective for the reasons given above – that is that the regime is seeking to deal with an evil which does not exist, being venal or dishonest behaviour on the part of member firms.

The price of such a change would be inconsistency and unfairness in that identical or similar offences will attract enormously different sanctions depending where the employed member

happens to work. It would also cause unnecessary conflicts of interest between members and member firms as explained below.

The sanctions paper sets out five levels of misconduct, including level 1. This is stated to relate to cases in which "*the misconduct was isolated, unintended, any potential harm was limited in degree and the misconduct was unlikely to do more than minimal damage to public confidence in the standards of conduct of members or member firms and the quality of corporate reporting. The Member/Member Firm took immediate steps to address the misconduct and reported the misconduct to the AADB of its own volition*".

Assuming for these purposes that behaviour of this sort is properly subject to sanction by the AADB, we do not understand why the penalty for such misconduct would be a penal deterrent based fine built around the turnover of the firm within which the individual concerned may happen to work.

We agree that sanctions should be high if a firm engages in reckless or intentional misconduct (and we are confident that past tribunals would have awarded much higher fines if they had identified such behaviour). At level 1 however there is no suggestion that the firm is, at an institutional level, guilty of any failing – the error was "*isolated*" and "*unintentional*" – and there is no behaviour on the firm's part to deter. It is very difficult to see why the sanctions attaching to behaviour at level 1 (and indeed across the board) need to be based on the need to deter behaviour which is not relevant to the facts of the case.

It seems to us that the proposed sanctions are not so much about deterring misbehaviour or incentivising good behaviour in members and member firms as they are about demonstrating that the regulator and the regulatory process is robust. We do not think that that is necessarily an inappropriate objective – the public should have confidence in the robustness of financial regulation generally. However, there is clearly a limit to the weight that should be given to this lone factor and the presentational need to show the regulator is robust is not a sufficient justification for the injustice created by imposing very high punitive sanctions in relation to simple errors. The sanctions regime in these complex professional environments cannot be driven entirely by the perceptions of the uninformed observer as to what level of fine would actually hurt a Big 4 firm.

Unintended consequences

The sanctions paper addresses the potential impact of the proposed changes at section 5 of the paper. The paper dismisses the suggestion that good candidates will be discouraged from entering the profession by a more punitive sanctions regime. This may or may not be the case but we are concerned that the proposed sanctions can only have a negative effect on the auditing part of the accounting profession.

The bulk of the cases coming before the AADB have related to the audit process and, in particular, the audit of substantial enterprises. The FRC has emphasised the primary importance of ensuring that financial reporting is robust and accurate. This requires that talented accountants should wish to make their careers as auditors and that the larger firms should be motivated to support their auditing functions.

You will be aware, however, that the commercial, legal and regulatory environment for auditing is very difficult. This is one of few areas of professional life in which the professional is not able contractually to limit his liability in the event that his client suffers loss and alleges that this was in some way caused by an error on the part of the professional. This is unfortunate as experience demonstrates that the very largest professional liability claims relate to the audit

process and that there is an unrealistic expectation as to what an audit can realistically achieve.

The FRC's recent paper on "audit scepticism" suggests that additional burdens should be placed upon auditors to look behind the judgement of management and substitute their own. This appears to us (although it is a separate topic) to create a very much heavier burden for the auditor, to increase the expectation gap between what is practically achievable and what is expected of the audit process and to raise the risk of regulatory sanction and civil claims.

Parliament has recognised that it is desirable that auditors should be able to limit their liability but, unfortunately, the 2006 Companies Act has failed to put in place a practical regime to achieve this objective. As such, auditors are exposed to the possibility of very large claims.

The attractiveness of audit as a career and as an area in which the largest firms should continue to invest cannot be assisted by imposing a punitive sanctions regime (which is most likely to attach mainly to the audit practice). If the sanction for a simple error in the audit process (in addition to open ended civil liabilities) is a meaningful percentage of the overall turnover of an enterprise (which will be much bigger than the turnover of the audit practice) the economics of running an audit practice must become problematic.

In fact of course audit is a very closely regulated area. The AIU performs, extremely well, an invaluable role in ensuring that audit standards are adhered to and the reality is that in the context of thousands of audits each year of highly complex organisations and despite the essentially judgmental nature of the audit process there are but a handful of referrals to the Board every year in respect of alleged errors. This seems to us to suggest that the audit process is in fact working as well as it can and there is no need to burden the sector with additional risk.

The Position of Individuals

The paper states (paragraph 3.21) that "*a member firm clearly has a responsibility to uphold appropriate standards of conduct by those who act on its behalf. It must also accept responsibility when those acting on its behalf fail to adhere to the standards of conduct reasonably to be expected of them*".

Such a proposition is unexceptional as a statement of ordinary civil law principles of loss allocation. If A engages in a business for profit and one of A's agents causes a third party loss then it is appropriate that A bears that loss essentially as a cost of doing business. This is the principle of vicarious liability.

It seems to us to be a wholly improper to apply that principle when seeking to put in place a regime based around deterrence. It is, of course, important if an audit manager acts dishonestly that he be subject to severe sanction. We understand that would be the approach under the old regime and proposed regime. If, however, he has deceived his employer as well as his client why should that sanction be multiplied many times and applied to the firm simply on the basis that the firm has a high turnover? If, of course, the employer's processes are negligently weak a severe sanction may be appropriate. If that is not the case the firm is being punished simply for being unlucky. We cannot see how it can possibly be appropriate to treat the firm as if it too were dishonest or to visit that firm with a sanction which is designed to deter it from behaviour it could know nothing about.

More typically, of course, a member may be caught up in the ADDB process who is not guilty of dishonesty but is accused of some sort of error. If the case against that individual were proven, the sanction in respect of his unintentional error might be a few tens of thousands of

pounds. As we understand the present suggestion, the member firm would be deemed to be responsible for that behaviour and would be subject, as a starting point, to fees set by reference to a percentage of the firm's turnover. If that individual happens to work for a big firm that would lead to a sanction of millions of pounds in respect of a relatively minor problem. That would clearly be very unfair on the member firm but it may also lead to difficulty for the member himself.

The sanctions regime envisages that discounts should be allowed against sanctions to member firms who make an early admission. That seems in and of itself a sensible suggestion. In an environment, however, in which the sanction falling on a member firm may be grossly disproportionate to the problem this could clearly lead to a very significant conflict of interest between member firms and individual members who may happen to work for that firm. It may be in the firm's interest (to the tune of millions of pounds) to deny the member the opportunity to fight his case for fear of a punitive sanction. The interests of the individual are likely to be crushed by urgent economic considerations.

Dealing then with the Board's questions as set out in the sanctions consultation paper:

1. **Do you agree with the Board's objectives and approach to sanctions guidance?**

   We do not agree with the Board's approach for the reasons set out above. An element of guidance to tribunals as to the matters to take into consideration is, of course, appropriate. The regime as envisaged seems to us to be inappropriate.

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?**

   We consider this question is very carefully crafted so that it is difficult to answer in the negative. In fact, we consider that the tribunals' historic approach to the setting of sanctions reflects the nature of the cases coming before the tribunals very much more closely than the suggested sanctions regime put forward by the Board.

3. **Do you agree that the sanctions imposed by tribunals should act as a credible deterrent and proportionate to the seriousness of the misconduct and to circumstances of the case, including the financial resources of members and the size of financial resources of member firms?**

   We do not agree for the reasons set out above. Clearly, sanctions should be proportionate to the seriousness of the misconduct and circumstances of the case. That has been the approach of the independent tribunals who have set sanctions in the past. The distortion of sanctions to reflect the financial resources of individual member firms is, in our view, inappropriate.

4. **Have we included the sort of factors in the sanctions guidance that you would expect to see taken into account by tribunals?**

   The factors listed at paragraphs 4.7 and 4.78 of the consultation paper appear to us to be entirely sensible.

5. **Are there any factors you believe tribunals should take into account when deciding sanction that we have overlooked?**

   No

6. Do you agree that there needs to be an adjustment to the level of fines imposed in AADB cases?

7. If so, what adjustment do you consider to be appropriate?

We do not agree that the sanctions regime needs adjustment. The fines imposed for instance on PricewaterhouseCoopers in relation to JP Morgan seem to us to be very significant.

8. What is your view of the alternative mechanisms proposed for calculating fines?

Given that each of the mechanisms is designed to arrive at the same place, each of the mechanisms described appears to us to be inappropriate for the reasons given above.

9. What level of turnover/income do you consider would be appropriate in respect of each mechanism?

We do not, for the reasons given above, consider that such concepts should be applied in setting a sanction.

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?

There are already very significant deterrents attaching to the AADB process. A reference to the AADB is very damaging to a firm's brand and any adverse award clearly has an additional damaging effect. The costs regime is so designed that it is almost impossible for member firms to get their costs back even if they successfully defend their work. As such the, often considerable, costs incurred by the AADB are part of the sanctions process and we do not understand why it is just or appropriate that those costs should be discounted when considering the overall sanction applied to the firm or member as part of this process.

11. Do you have any other comments about the proposed structure or content of the sanctions guidance?

No. We consider that the existing regime is appropriate. It may be appropriate to give tribunals additional guidance as to the sort of factors that should be taken into consideration. We do not believe that those factors should include the financial resources of member firms.

Yours faithfully

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