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Our ref
2082
Your ref

Date
10 July 2012

By post and by email

Dear Ms Colban

AADB Consultation Paper - Sanctions Guidance to Tribunals (April 2012)

Thank you for the opportunity to respond to the Consultation Paper. We set out below our comments by reference to the specific questions raised in the Consultation Paper.

We note that on 28 June 2012 the FRC published its Consultation Paper setting out proposed changes to the AADB Scheme. As a general observation we consider it would be preferable to finalise the exact basis on which the AADB Scheme will operate and only then seek to consult on and determine the form of any sanctions guidance. Having a consultation on sanctions guidance followed by a consultation on the Scheme strikes us as being somewhat of an illogical approach.

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

We support the AADB's efforts to make the approach to the imposition of sanctions more transparent and consistent. Accordingly, we consider it is appropriate to issue guidance in order to assist Tribunals adopt a consistent approach to the determination of sanctions in any particular case. However, we consider that, within the boundaries of that guidance, the Tribunals appointed by the AADB are best placed to exercise their own judgment concerning the appropriate sanctions and, in the case of financial penalties, the amount of such penalties which should be imposed in any particular case. We therefore oppose the attempt to introduce into the proposal a set guidance tariff premised simply on the financial performance of the firm or member the subject of the investigation to be used as the starting point by a Tribunal for setting a financial penalty.

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We note that the central theme permeating the Consultation Paper is the AADB's concern that sanctions maintain relevance; in particular the AADB's view that there is a need for an increase in the level of fines payable for misconduct in the sorts of cases heard by AADB Tribunals. We consider that the concerns expressed in the Consultation Paper regarding the level of fines appear somewhat misplaced and on any basis are premature in view of the fact that to date there is only a very limited track record of AADB Tribunal decisions to which regard can properly be had.

As regards the aim of increasing penalties, the AADB's justification seems to be that higher financial penalties are needed to fulfil the need for credible deterrence for future misconduct.

We are concerned at the prominence which the Consultation Paper attaches to seeking to secure higher penalties and the heavy reliance placed on its purported deterrent effect in circumstances where no evidential basis has been provided on which to establish such a connection. We note that the AADB does not appear to have undertaken (or at any rate identified) any research which considers the extent to which there is a correlation between higher fines and deterrence. In the absence of any credible research, we have considerable doubts as to the reliability of the underlying premise.

We consider that the question of deterrence and what this means in a professional disciplinary context such as that undertaken under the AADB Scheme needs to be the subject of more careful consideration. The definition of misconduct under the Scheme covers a broad range of activity ranging from negligence on the one hand to active wrongdoing on the other. Typically the clients whom we advise who face scrutiny under the AADB Scheme (and similar professional regulatory schemes) do so because of a mistake which is alleged to have arisen rather than due to misconduct in the sense in which that word is understood by laypersons (which carries with it connotations of deliberately improper or reckless behaviour).

Although increased efforts can always be made to improve standards, it is unrealistic to consider that increasing the amount of fines imposed by Tribunals will have any marked effect on the occurrence of negligence. In particular, it is our experience that our clients take very seriously their obligations and go to great lengths to ensure that their activities are carried out in accordance with the standards required of them. Although issues do inevitably arise, our experience suggests that this rarely does so because of a conscious decision not to be concerned about relevant standards.

We consider, therefore, that firms are already well incentivised to seek to comply with their professional obligations, in particular, the reputational and business consequences of getting it wrong, the potential impact on individuals in terms of their own personal responsibilities as members and firms' broader relationships with the AADB, the FRC and the ICAEW. Accordingly, we do not consider that increased penalties will have any appreciable increase in the deterrent effect.

In the case of those who participate in misconduct at the deliberate wrongdoing end of the misconduct spectrum, we consider that the motivations of such firms and/or individuals will be wholly different from those who make occasional lapses i.e. the negligence end of the spectrum of misconduct. We doubt however whether the risk of an increased penalty is

likely to have an impact on such conduct and consider it debateable whether this is the correct tool for improving compliance in that context.

By way simply of illustration and to highlight our concerns as to the proposed approach, we note that the SEC hands out very large fines every year. However, this has had no appreciable long term impact on reducing the levels of market abuse or adherence to SEC systems and controls requirements.

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?**

As mentioned above, we consider it would be helpful to have guidance available for Tribunals that establishes a framework which sets out the relevant factors which should be considered when determining the imposition of sanctions. However, we do not agree with the proposed indicative sanctions guidance insofar as it seeks to place heavy emphasis on the alleged deterrence effect of higher fines and introduces the concept of having a starting point which is determined, in the case of a member firm, to a percentage of its turnover.

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?**

We consider that the sanctions guidance places too heavy a weight on deterrence which we consider is simply one of a number of matters which should form the subject of consideration when imposing a penalty. We do not agree that it would be appropriate to have sanctions guidance which introduces the concept of a starting point for a fine at a certain percentage of a firm's turnover. We consider that tariff-based fining is a particularly blunt instrument and that such an approach is likely to lead to fines which are completely disproportionate to the nature of the underlying misconduct. We fail to see, for example, why in the case of negligence based misconduct the same error should attract significantly different levels of fine depending on the size of the underlying firm simply on the basis of an unproven assertion that this is justified on the basis that it satisfies the principle of deterrence.

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

The guidance includes the sort of factors that we would expect to be taken into account by Tribunals. As mentioned above, we consider that a credible basis has not been made out to support the proposition that higher fines equate to greater deterrence and, therefore, have significant reservations about this element of the guidance.

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

The guidance does not recognise the significance deterrent factors which are already at play and the impression left from reading the Consultation Paper is that there is simply a

desire on the part of the Board to ensure that Tribunals impose higher fines by reference to the size of the firm's turnover rather than principally by reference to the nature of the actual misconduct.

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

We do not consider that there is a need, necessarily, to increase fines in order to achieve a deterrence objective. In particular the proposal to assess fines by reference to a firm's turnover seems to us to give rise to the likelihood of unfair and disproportionate outcomes. We note that there is reference in the Consultation Paper to the need to ensure that sanctions maintain relevance in the current environment. We also note that there is reference to increased revenues having been generated by member firms and there has been a shift in the extent and importance of work being undertaken by firms. The evidential basis for these statements in the Consultation Paper is not clear. At the moment, we are concerned that the Consultation Paper contemplates the imposition of a sanctions regime which seeks to result in higher fines simply to assuage concerns about the public perception of the Scheme rather than necessarily because this is justified within the parameters of the accepted principles for imposing sanctions.

As mentioned earlier in our response, we do not consider that there has been a sufficient track record of AADB Tribunal fines on which to make any reasoned assessment or to give rise to a concern about the level of awards which might be determined by Tribunals in respect of future cases. We do consider that Tribunals are best placed to determine the level of fines which are appropriate to impose having regard to all the particular facts of the case which will have been presented to them. Whilst we consider it is useful to have guidance that assists a Tribunal to have regard to the relevant factors, we do not consider the imposition of set financial starting points for penalties referable to a firm's financial size to result in a fair outcome and therefore oppose the introduction of such measures.

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

Please see response to 6 above.

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

As set out above, we are against the use of tariffs which determine a notional starting point for a penalty. We consider that the Tribunal is best placed to determine what is a proportionate penalty having regard to the nature of the misconduct and to make adjustments to that figure as appropriate.

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

We do not consider the use of turnover/income a fair basis on which to determine a notional starting point for penalty in a professional regulatory system.

Herbert Smith

Date

10 July 2012

Letter to

Anna Colban

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 should not be taken into account save insofar as this impacts on the ability of the member or member firm to meet the proposed penalty.

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

We note that the guidance proposes that the Tribunal should have regard to the extent of a firm of member's prior disciplinary record. We consider that in the same way that in a criminal context convictions become "spent" after a certain period of time that the Tribunal should only be permitted to have regard to disciplinary offences which have occurred within a set number of years of the time when the Tribunal is imposing a sanction.

If you have any queries about our comments, please contact Stephen Flaherty on 020 7466 2082.

Yours faithfully

Herbert Smith LLP

