ICAS RESPONSE TO THE FRC CONSULTATION PAPER

Disciplinary Schemes Proposed Changes

Background

The Institute of Chartered Accountants of Scotland (ICAS) received its Royal Charter in 1854 and is the oldest professional body of accountants in the world. We were the first body to adopt the designation "Chartered Accountant" and the designatory letters "CA" are the exclusive privilege of Members of ICAS.

ICAS is a professional body for 19,000 members who work in the UK and in more than 100 countries around the world. Our CA qualification is internationally recognised and respected. We are a Recognised Qualifying Body (RQB) for statutory audit. We are also a Recognised Supervisory Body (RSB). We have around 240 audit registered firms, of which five firms are involved in the audit of public interest entities and fall within the scope of the FRC's Audit Inspection Unit (AIU).

All 19,000 Members and our audit-registered firms presently fall within the scope of the FRC Disciplinary Scheme ("the Scheme").

Consultation

As a Participant Body, we welcome the opportunity to comment on the various proposals to amend the Scheme. Earlier this year, ICAS commented on the proposals for reform of the FRC and minor amendments to the Scheme were approved by our Council on 24 August 2012 to enable the revised structure to be implemented (with reference to the newly established Conduct Committee). We have also recently commented on proposals to introduce sanctions guidance for Discipline Tribunals operating under the Scheme. Whilst we have been content to comment on the individual consultation papers we would encourage the FRC to consider both consultations as a holistic exercise as we believe that there are a number of points which cannot be viewed in isolation.

There are some matters that the present consultation does not include, notably a review of the definition of "Misconduct" and the future scope of the Scheme. We firmly believe that only matters of serious public concern involving the audit (or other financial reports) of publicly traded companies should fall within the scope of the FRC and we would welcome an opportunity to meet with the FRC and Participant Bodies in due course to discuss these issues in more detail.

Key Points

ICAS is committed to protecting the public interest and we will always welcome reforms which seek to deliver this outcome. There are many aspects of the current proposals which we would wholly support. There are others which are of significant concern, and which we believe may expose the FRC's disciplinary arrangements to unnecessary legal challenge.

1. Consultation (launching an investigation and preliminary enquiries): It is our desire that the FRC and each Participant Body have a good working relationship as co-regulators of the profession. We would be content for the current formal requirement for consultation to be removed from the Scheme. This would be on the understanding that, on an informal basis, early consultation with the Participant Body will be the default starting position for all investigations. Our position in broadly similar in relation to the removal of the requirement for a preliminary enquiry protocol. Both concessions would be on a review period after one year to establish whether such informal consultations had actually occurred. ,
2. Future Scheme Amendments: We fully support the current level of operational independence of the Scheme but we do not believe that the public interest is in any way prejudiced by the

requirement for each Participant Body to approve the Scheme. Constitutionally, the ICAS Royal Charter requires our Council to approve any changes to the Scheme. The Royal Charter is the means by which the Council delegates its powers to the FRC and it is important to recognise that the Scheme is not constituted independently of the profession (that is, the FRC presently derives all investigative and disciplinary powers from the Participant Bodies which have adopted the Scheme into their respective Rules and Royal Charters). We believe that there is a constitutional barrier which would prevent ICAS from agreeing to any such change to the Scheme without the approval of the membership in general meeting and the Privy Council.

3. Settlement of Cases: The nature of the cases which are subject to FRC investigation require transparency and we believe that there is an expectation that such matters will receive a public airing in the interests of transparency and accountability. In relation to the few cases which could be capable of settlement, we would make the following observations:-
    - The Case Management Committee should have formal oversight of the decision to enter into settlement negotiations.
    - "Settlement Approvers" should be individuals who are independent of the investigative process and have had no prior involvement.
    - Full publicity of any settlement agreement should be an absolute requirement. Such publicity would need to provide clear information to the public on the issues involved and also an explanation of the rationale for agreeing a settlement with the Member or Member Firm.
4. More generally, we would like to see the role of the Case Management Committee expanded formally to include financial oversight and management of case costs.
5. Timescales: Whilst the Scheme sets out proposed timescales within which a Member or Member shouldreview of a draft Formal Complaint, we would encourage the FRC to consider whether the decision-making process surrounding the presentation of a Formal Complaint to the Conduct Committee should be viewed as one continuous process with a number of corresponding timescales (that is place respective obligations on the Executive Counsel and the Member or Member Firm)
6. Interim Orders: We consider that the power of interim suspension of membership or licences should ordinarily remain with the professional body. If granted the power to impose interim orders, we would expect the FRC to only exercise such rights in exceptional cases and we would require a review date within 12 months in order to ensure consistency with our own Rules so that a Member or Member Firm would not be unfairly treated under the FRC Scheme.
7. Investigation Tests: We have no objection to the proposed change of terminology from "act of misconduct" to "Misconduct". We do, however, consider that this raises a more general point over the definition of "Misconduct" which remains as yet unchanged. While there are clearly matters with which the FRC should be concerned and these ought properly to be investigated independently, any "Misconduct" should be serious and reprehensible in order to meet "the second criterion". Misconduct has a high threshold and the terminology should not be applied to each and every departure from standards. Moreover, we do not believe the FRC should be concerned with *any* departure from standards (this is the role of the Participant Body either through its regulatory or disciplinary procedures). The FRC should only be concerned with actions which fall *significantly* short of the standards expected of a Member or Member Firm. Without an attempt to revisit the definition of "Misconduct" the apparent confusion or uncertainty which has arisen in the past as to the sorts of cases the

FRC investigates will not improve and a real opportunity to improve the operation of the Scheme will have been missed.

8. Appointment of Tribunals: We are deeply concerned by the proposal that the Conduct Committee shall have a significant role in the appointment of the Discipline Panels and Tribunals. The Conduct Committee is the body which decides whether a Formal Complaint should be presented to the Tribunal. Any process which blurs the lines between investigation and discipline will expose the FRC to legal challenge. We are deeply concerned by this aspect of the revised scheme and we would encourage the FRC to seek further legal advice in this regard and/or to clarify the basis for this proposal.
9. Costs After Admissions: We have no objection in principle to the proposal to remove the provisions relating to costs incurred after an admission is made by a Member or Member Firm but the recent consultation paper on sanctions set out a number of points in relation to "Discount for Admissions" which related to reduction of the financial penalty to reflect positively on a Member or Member Firm's admissions. To now expressly remove any discount in respect of costs will, in our view, present an unhelpful disconnect between penalty and costs.
10. Co-operation of Former Members and Former Member Firms: Our Rules do not provide for the ability to require Former Members or Former Member Firms to co-operate with ICAS. We therefore do not consider that we are in a position to delegate this power to the FRC.
11. Sanctions: The consultation paper is largely silent on the sanctions proposals which formed the subject matter of a separate consultation exercise. ICAS would need to see more details of additional sanctions which may be in contemplation by the FRC..
12. Successor Firm Liability: The question of successor firm liability is broadly speaking a contractual matter. We would also like to understand the interface between this proposal and the recent sanctions guidance. For example, we consider that it would be fundamentally improper to impose a financial penalty based on the size of the Successor Member Firm as at the date of the decision, where any "Misconduct" is attributable to a different entity. This proposal could lead to circumstances where the size of a penalty increases considerably simply because a smaller Member Firm has been purchased by a larger Member Firm.

Our detailed comments on the present consultation are set out below.

Q1

Should the Schemes be amended as set out in paragraphs 3.3 to 3.11 above so as to enhance the independence of the disciplinary arrangements?

There are four broad amendments set out in paragraphs 3.3 to 3.11 of the consultation paper and we would comment as follows:-

Launching an investigation (Paragraph 5(8))

The requirement to consult with the Participant Bodies has been a feature of the Scheme since it was established. In essence, the primary regulatory responsibility rests with the Participant Body, which is reflected by the delegation of investigative and disciplinary powers by each of the Participant Bodies to the FRC. ICAS still believe it is only right and proper that each Participant Body should be consulted on any decision or proposal to launch an investigation against a Member or Member Firm. That having been said, we fully recognise the need for the FRC to conduct investigations in a more effective, efficient and timely manner. The removal of any obvious points of delay in the process will be in the best interests of the public and also Members

or Member Firms which are subject to investigation, though we doubt that the consultation process of itself has been a significant cause of delay.

It is our desire that the FRC and each Participant Body have a good working relationship as co-regulators of the profession, and in this spirit we would therefore be content for the current formal requirement for consultation to be removed from the Scheme. This would be on the understanding that (1) on an informal basis, early consultation with the Participant Body will be the default starting position for all investigations and (2) the FRC would commit to a review after a period of one year to establish that such informal consultations have taken place.

Preliminary enquiries (Paragraph 5(10)

It is disappointing that the preliminary enquiry protocol which is currently provided for in the Scheme was never formalised and therefore remains untested.

We do accept that the regulatory landscape has changed over the last few years and that the FRC has an important role to fulfil in preserving trust in the capital markets. Subject to our comments above in relation to the need for the FRC to engage effectively with the Participant Bodies, we would be content to remove the requirement for such preliminary enquiries to be conducted in accordance with a protocol.

Scope extensions (Paragraph 6(8))

In principle, we have no objection to the proposal to remove the requirement to consult with the Participant Bodies on the extension, or indeed the reduction of the scope of the investigation. We believe that a good working relationship between the FRC and any relevant Participant Body ought to provide a channel for scope extensions to be discussed openly, without the need to consult formally. Again, this would be on the understanding that the FRC would commit to a review after a period of one year to establish that such consultations have taken place.

Amending the Scheme (Paragraph 18)

As we highlighted in our response to the consultation paper on reform of the FRC (January 2012), we fully support the current level of operational independence of the Scheme but we do not believe that the public interest is in any way prejudiced by the requirement for each Participant Body to approve the Scheme.

Constitutionally, the ICAS Royal Charter requires our Council to approve any changes to the Scheme. The Royal Charter is the means by which the Council delegates its powers to the FRC. We understand that there may be similar arrangements in place for other Participant Bodies. In this respect, it is important to recognise that the Scheme is not constituted independently of the profession as it derives all of its investigative and disciplinary powers from the Participant Bodies (which have adopted the Scheme into their respective Rules and Royal Charters). In other words, the Participant Bodies contractually bind each and every Member and Member Firm to the external disciplinary arrangements (irrespective of whether or not they carry out statutory audit under the Companies Act 2006, being the statutory basis for the Scheme). Given the powers under the Scheme are acquired by way of delegated authority, we firmly believe that the Council must retain the right to approve any changes to those disciplinary arrangements on behalf of the Members and Member Firms.

We recognise that the FRC proposes to provide a dispute resolution mechanism for dealing with instances where a Participant Body cannot or will not agree to amendments to the provisions of

the Scheme. However, as a matter of principle, we believe that the consent of the Participant Body is a key feature of the FRC's disciplinary arrangements and any outcome which was inconsistent with a Participant Body's own Rules would be difficult to enforce.

On that basis, we are strongly opposed to the proposals set out in paragraph 18 which invite ICAS to provide the FRC with an unfettered delegated authority to amend the Scheme in the future. We believe such a proposal is inconsistent with the principles of good governance and that, in responding to this aspect of the consultation paper, there is a balance to be struck between the public interest and the need to represent the interests of our Members and Member Firms (the majority of which do not conduct statutory audit work and are only brought within the scope of the FRC's disciplinary arrangements by virtue of their membership). We would also highlight that there is a significant constitutional barrier which would prevent ICAS from agreeing to any such change to the Scheme without the approval of the membership in general meeting and the Privy Council.

Q2
Are the proposals to conclude cases without the need for a tribunal hearing appropriate?

For a number of years, ICAS has had the power to conclude disciplinary cases without the need for referral to a tribunal for hearing, through the use of 'Consent Orders'. Therefore, we can recognise the need for disciplinary action to be carried out effectively and efficiently and that settlement can present an appropriate solution in certain cases. However, the inherent nature of the cases which are subject to FRC investigation require transparency and we believe that there is an expectation that such matters will receive a public airing in the interests of transparency and accountability.

While we accept that there are potential cost savings if cases can be determined without a need for a formal disciplinary hearing, we believe there is a greater risk of loss of public trust if cases are seen to be settled "behind closed doors". We consider that few cases would be capable of such a private settlement agreement. This is a point on which the ICAS Public Interest representatives are particularly insistent.

In relation to the few cases which could be capable of settlement, we would make the following observations:-

1. There is insufficient detail in the provisions as drafted to assess the practical and reputational implications of the proposed change. We would like to receive more information about how the process would operate in practice and, in particular, the role of the Case Management Committee. For example, we do not consider that it is appropriate for the Executive Counsel, at his sole discretion, to be able to decide which cases are eligible for settlement. Under our own structure it would be wholly inappropriate for the equivalent post to enter into settlement negotiations without prior consultation with the responsible regulatory committee (that is, our Investigation Committee). The consultation paper infers that the Case Management Committee would have an oversight role over settlement discussions (including the appropriateness of entering into such negotiations) but this has not been translated into the Scheme wording and we would like to see this safeguard incorporated into the Scheme.

2. We do not consider it appropriate that the "Settlement Approvers" are to be selected from members of the Case Management Committee, as such individuals may have an inherent interest in the negotiations from the outset. (Given the profile and nature of the cases which could be subject to this provision, we would welcome the appointment of individuals who are independent of the investigative process and have had no prior involvement. There is an expectation that the process for the conclusion of cases will be independent and it is important therefore that it is seen to be so (even where it can be demonstrated members of the Case Management Committee have no direct knowledge of, or prior involvement with any given case there is a an overriding need in matters of public concern to have regard to public perception).. That should mean that such decisions will made in the context of a process that is not only be independent in operational terms of the Participant Bodies but also of the FRC's own investigative process.

3. Given the importance of maintaining public confidence and transparency in the process, we consider that full publicity of any settlement agreement should be an absolute requirement. Such publicity would need to provide clear information to the public on the issues involved and also an explanation of the rationale for agreeing a settlement with the Member or Member Firm.

Q3
Do you agree with the role envisaged for the Case Management Committee?

We are broadly content with the role of the Case Management Committee as set out in the consultation paper but, regrettably, we do not feel that this role has been translated adequately into the current drafting of the Scheme.

There is one matter that we consider ought to be expressly stated within the terms of reference of the Case Management Committee; the management and effective oversight of case costs. The Participant Bodies are required to fund the case costs in full. This is a significant financial liability and to date there has been limited accountability by the FRC to a Participant Body for the costs incurred during the course of an investigation. The Participant Body ought be able to rely upon the Case Management Committee to maintain effective oversight over the selection and costs of external advice obtained by the Executive Counsel (or Alternative Executive Counsel). If such oversight has been conducted on an informal basis to date then we would like to see the role of the Case Management Committee expanded formally to include financial oversight and management of case costs.

Q4
Are the proposals to facilitate the timely completion of investigations and disciplinary proceedings appropriate?

We welcome any measures which are intended to reduce the time taken to conclude an investigation, while ensuring that the Executive Counsel is able to take all relevant factors into account before delivering a formal complaint to the Conduct Committee.

We accept that the absence of timescales has contributed to the delay of cases in the past, and we welcome the FRC's attempts to address this in the revised Scheme. However, we note that there is no timescale imposed under paragraph 6(11) (that is there is no corresponding timescale within which the Executive Counsel is required to consider the representations by a Member or

Member Firm, to seek legal advice on the realistic prospect of success and determine whether or not a formal complaint ought to be presented to the Conduct Committee). The introduction of timescales in relation to one aspect of the process alone does seem imbalanced. The FRC may wish to consider whether the decision-making process surrounding the presentation of a Formal Complaint to the Conduct Committee should be viewed as one continuous process with a number of corresponding timescales.

Q5

Should the Executive Counsel be able to seek an interim order against a Member or Member Firm? If so, are the proposed provisions appropriate?

The ICAS Rules provide for the grant of an interim order by a Discipline Tribunal where such an order is in the public interest. However, such applications are only made in the most exceptional cases as there are significant legal protections attached to membership, practicing rights and regulatory licenses. We consider that the power of suspension of membership or licences should ordinarily remain with the professional body and if we use such emergency powers on exceptional occasions we consider that the FRC will use them even less frequently. To justify such an order there will need to be a risk to client funds or a significant risk to the public interest. If the Scheme is revised to include interim orders then we would require a similar arrangement to our own Rules so that a Member or Member Firm would not be unfairly treated under the FRC Scheme.

We would also observe that the FRC disciplinary scheme is a complex arrangement and we believe that there is scope for regulatory conflict with decisions by the FRC's Monitoring Committee and/or the regulatory committee of the individual Participant Body.

Q6

Do you have any comments on the proposals to amend the investigation test?

We have no objection to the change of terminology (that is a change from "act of misconduct" to "Misconduct").

We do, however, consider that this raises a more general point over the definition of "Act Misconduct" which remains as yet unchanged.

The FRC has an important to role to play in maintaining trust in the capital markets. The Participant Bodies have an important role to play in maintaining trust in the accountancy profession. Those respective obligations should be complementary to each other. While there are clearly matters with which the FRC should be concerned and these ought properly to be investigated independently, any alleged "Misconduct" should be serious and reprehensible in order to meet "the second criterion".

Misconduct has a high threshold and the terminology should not be applied to each and every departure from standards. Moreover, we believe that it is time to review the definition as the FRC should not be concerned with *any* departure from standards (this is the role of the Participant Body either through its regulatory or disciplinary procedures). The FRC should only be concerned with actions which are *serious* and which fall *significantly* short of the standards

expected of a Member or Member Firm. Without an attempt to revisit the definition of "Misconduct" the apparent confusion or uncertainty which has arisen in the past as to the sorts of cases the FRC investigates will not improve and a real opportunity to improve the operation of the Scheme will have been missed.

Finally, the current Scheme does not allow for a matter to be remitted back to a Participant Body (either at the outset or during the course of the investigation). We understood that this was to be remedied in the current draft. If that is still the intention then we would welcome proposed wording for review in due course.

Q7
Do you have any other comments on the proposed Schemes or the points raised in this paper?

The consultation paper includes provision for the appointment of tribunals, post admission costs, obligations to co-operate with the Executive Counsel and Sanctions, which are not expressly covered under Questions 1 to 6 above.

We would like to respond to each of these proposals in turn. We would also wish to make some further observations on the Scheme which we believe require to be addressed in order to deliver an effective disciplinary scheme which is fit for purpose and will serve the public interest.

Appointment of Tribunals
As currently drafted the Scheme provides that the Conduct Committee shall have a significant role in the appointment of the Discipline Panels and Tribunals. ICAS has fundamental concerns over the terms of paragraphs 9(1), 9(2) and 9(7) and we would seriously question the validity of the current proposals.

The Conduct Committee is the body which delivers the Formal Complaint to the Tribunal. It is therefore involved in the investigation process and, in governance terms, it cannot be the body which appoints and selects the Tribunal which will hear the complaint.

The Discipline Tribunal needs to be seen to be independent of the Participant Bodies but also of the FRC's own investigative processes. Any process which blurs the lines between investigation and disciplinary arrangements will expose the FRC to legal challenge. We are deeply concerned by this aspect of the revised scheme and we would encourage the FRC to seek further legal advice in this regard and/or to clarify the basis for this proposal.

Post-Admission Costs
We have no objection to this proposal in principle but the recent consultation paper on sanctions set out a number of points in relation to "Discount for Admissions" which related to reduction of the financial penalty to reflect positively on a Member or Member Firm's admissions. To now expressly remove any discount in respect of costs will, in our view, present an unhelpful disconnect between penalty and costs.

Co-operation with Executive Counsel

The ICAS Rules do not provide for the ability to require Former Members or Former Member Firms to co-operate with our Investigation Committee or its officers or agents. We are therefore not in a position to delegate this power to the FRC.

Sanctions

The consultation paper is largely silent on the sanctions proposals which formed the subject matter of a separate consultation exercise. We would simply observe that ICAS cannot delegate a power to the FRC to impose a sanction which we presently cannot impose against a Member or Member Firm. ICAS would need to see more details of additional sanctions which may be in contemplation.

On a more general note, we would encourage the FRC to ensure that both consultations are considered as a holistic exercise as we believe that there are a number of points which cannot be viewed in isolation.

Regulations

The Scheme provides that Regulations will be made by the Conduct Committee (Paragraph 3(1)). Given the Scheme grants certain powers to the Conduct Committee it is inappropriate for the Committee to have the final right of approval of any Regulations. This power must rest with the FRC Board.

Complainant

We note that paragraph 9(10) provides that the Complainant shall be the Executive Counsel. If the Conduct Committee is responsible for the submission of the Formal Complaint the we consider that it should be named as the Complainer, rather than the Executive Counsel.

Successor Member Firm

The question of liability is broadly speaking a contractual matter between firms and we remain cautious about the ability to scope such successor firms into the Scheme.

We would also like to understand the interface between this proposal and the recent sanctions guidance. For example, we consider that it would be fundamentally improper to impose a financial penalty based on the size of the Successor Member Firm as at the date of the decision, where any “Misconduct” is attributable to a different entity. This proposal could lead to circumstances where the size of a penalty increases considerably simply because a smaller Member Firm has been purchased by a larger Member Firm.

In conclusion

We are grateful for the opportunity to comment publicly on the proposed scheme and we look forward to working with the FRC and the Participant Bodies in order to ensure the deliver of a comprehensive scheme for the future.