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Our ref: ICAEW Rep 90/12

Your ref:

Anna Colban
Secretary to the AADB
Financial Reporting Council
5th Floor, Aldwych House
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London WC2B 4HN

Dear Anna,

Sanctions Guidance to Tribunals

ICAEW is pleased to respond to your request for responses to the consultation paper on sanctions guidance to tribunals published by the FRC on 18 April 2012.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

CONSULTATION ON THE ACCOUNTANCY AND ACTUARIAL DISCIPLINE BOARD SANCTIONS GUIDANCE TO TRIBUNALS

Response submitted in July 2012 by ICAEW to a Financial Reporting Council consultation paper on AADB Sanctions Guidance to Tribunals published April 2012.

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WHO WE ARE

1. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

2. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

INTRODUCTION

3. ICAEW's comments on the consultation paper Accountancy and Actuarial Discipline Board (AADB) Sanctions Guidance to Tribunals (the paper) published by the Financial Reporting Council (FRC) are set out in this document.

4. As a regulatory body exercising responsibilities deriving from statute, ICAEW fully supports indicative guidance on sanctions being available to disciplinary tribunals. Indeed, we publish sentencing guidance to our own disciplinary tribunals, which is subject to regular review. Where there is evidence of misconduct before the tribunal, we acknowledge and support the need for there to be a range of appropriate and proportionate penalties.

5. Consequently, we fully support the case for indicative sanctions guidance to be available to assist the AADB Tribunals in determining appropriate sanctions where misconduct is proved. As the paper says, sanctions guidance has been adopted by many disciplinary regulators and where absent this has resulted in judicial criticism. Further, we agree that sanctions guidance should be consistent with, and uphold, established principles of good regulation.

6. It is important that disciplinary tribunals make their decisions and impose sanctions as a result of a fair, reasoned and transparent process. The approach to sanctions policy and the sanctions imposed should be consistent and proportionate. Firms and individuals facing complaints of misconduct should know the range of sanctions that may be imposed and be confident that the same approach will be used in each case. There should also be a consistent approach by regulators dealing with similar matters as to what is misconduct and the range of sanctions for similar failings should be consistent and proportionate. Sanctions policy should focus on protecting the public, correcting and deterring misconduct and maintaining the reputation and standards and conduct of the profession.

7. Insofar as the indicative guidance set out in Appendix A of the paper upholds the principles referred to above we fully support it.

8. However, in our view certain aspects of the guidance are inconsistent with these principles and/or apply them disproportionately. Firstly, the paper appears to focus excessively on fines at the expense of other sanctions that may, alone or in combination, provide a more appropriate sanction in the circumstances of the case. Whilst the draft guidance does include non-financial sanctions there are others that, we suggest, would provide a more proportionate range of sanctions given the fact that misconduct is more likely to arise through error than

wilful or reckless behaviour or systemic failings. For example, in relation to member firms, the sanctions available could include requirements to make functional changes in supervisory arrangements and/or engagement team organization. Or, in the case of members, to require additional professional education or training to minimise the risk of future misconduct.

9. Secondly, the paper does not sufficiently emphasise the impact that a disciplinary case and sanction may have on a firm's or individual's reputation. This is likely to be as important a deterrent as the sanction imposed and reflects the need for a proportionate range of sanctions to be available to the Tribunal.

10. Thirdly, the paper does not, in our view, set out a persuasive case for what appears to be a radical change in the way that fines will be calculated i.e. by reference to a percentage of the group turnover of the firm or the income of the individual. This marks a very different approach from that of the AADB (and its predecessors) tribunals and may lead to the imposition of an inappropriate increase in fines even for straightforward failings i.e. those resulting from error rather than wilful or reckless behaviour or systemic failings. As previously said, in our view, such an approach fails to have sufficient regard to the nature of audit business in practice and the financial impact of a fine for misconduct on a firm's reputation. It also fails to differentiate sufficiently between misconduct arising as a result of simple error or inadequacy and that arising through wilful or reckless behaviour. It further risks being out of step with other domestic and international regulators concerned with audit business.

11. The prospect of significantly increased (and potentially unlimited) fines could also have serious implications for individuals and undermine their appetite for being members of boards and professional bodies if that exposes them to significantly increased personal risk. That may undermine the expansion and development of professional services firms generally. Nor will it encourage membership of professional bodies which have encouraged high standards for generations.

12. We have set out below our more detailed comments on the proposals. All our comments in this response constitute our response to the paper and not just those made in relation to the specific questions raised in the paper.

MAJOR POINTS

13. We have reservations about the proposals for determining the appropriate level for fines and concerns about the potential consequences of a significant increase in the level of fines. In particular, we highlight the following issues which should, in our view, be clarified and/or addressed before the Guidance is finalised.

The mechanism for calculating fines

- Whilst the paper refers to the Tribunal's view in the JP Morgan Securities Limited case that historically fines have been too low in relation to misconduct in audit business, it omits reference to the fact that the Tribunal went on to clearly say that it is not possible to assert that a fine should stand in any specific relationship with a turnover or net profit of the defendant.

- The proposed mechanisms for determining the appropriate fine in a particular case appear complex and may, therefore, give rise to practical issues for the Tribunals in determining the appropriate level of a fine. Further, the absence of the relevant percentage to be applied in calculating the base point for fines gives no certainty as to the level of fines other than that, it is assumed, they will be significantly higher than under previous regimes. It also makes it difficult to frame a response to the proposals. It is not clear to us whether the

individual Tribunals are expected to determine the appropriate percentage or whether this will be done by others.

The link to annual group turnover

- Although the absence from the paper of the relevant percentage of turnover/income to be applied in the calculation of fines makes it difficult to ascertain the level of increase in fines that the FRC has in mind in its proposed mechanisms, the tenor of the paper strongly suggests a significant increase to levels of fines comparable with those sometimes imposed in FSA cases. For example, in the JP Morgan case the FSA imposed a financial penalty of more than £33m on JP Morgan for breach of the FSA's Principles and Client Money Rules whereas the penalty imposed on the auditors by the AADB Tribunal was £1.4m.

- A mechanism which links the level of a fine to the annual group turnover of a firm will result in fluctuating levels of fine for similar failings in similar engagements. For example, the annual group turnover of the largest audit firm is significantly higher than the fourth largest firm. Consequently, a fine for similar failings or misconduct could be significantly higher for the larger firm. As we say elsewhere, we have concerns that punitive financial sanctions may undermine the growth and development of professional services firms and the sector generally.

- The link to group turnover begs the question of what constitutes the group given that the structure of the larger firms in particular can be complex involving national and international arrangements. For example, one of the larger firms is a European LLP with a turnover of 4.5 billion euros and a profit of 900m euros in 2011. Would these be the relevant figures for calculating the fine in an appropriate case or would the Tribunal be expected to disaggregate the UK revenues?

The deterrent effect of fines

- We consider that the deterrent effect in calculating the level of fines is overplayed. Whilst deterrence is clearly a legitimate factor for Tribunals to have regard to in determining sanctions it should not drive sanctions policy to the degree that financial penalties are punitive and disproportionate to the misconduct in question. Audit failings have historically rarely involved wilful or reckless misconduct by firms or individuals. Where they do, that misconduct should be dealt with appropriately and proportionately. But the paper fails to clarify why significantly increased fines are appropriate for failings of the kind previously considered by AADB (and predecessor) tribunals in the overwhelming majority of past cases and other similarly concerned disciplinary tribunals.

The impact of individual fines on directors, non-executives and boards

- We have concerns about the potential impact of significant fines on individuals and the corresponding impact on corporate governance. In particular, individual executive and non-executive board members who are Chartered Accountants will, under the proposals in the paper, be liable to significant additional sanctions above and beyond those of other board members. This will surely undermine the concept of the unitary board collectively responsible for the business and compromise the recruitment of experienced non-executives in an already challenging market. The paper appears to assume the effect of increased fines will be felt mainly by the audit firms and/or executives without considering the position of company directors, in particular non-executives. Further, contrary to the assertion in the paper, we do consider that there is a real risk that the potential for individuals to suffer significant and punitive fines may discourage them from becoming Chartered Accountants in the first place and, where existing members, may discourage continuing membership of the accountancy bodies.

Alternative mechanisms for calculating fines

- The paper does not consider alternative bases for calculating fines where a financial penalty is an appropriate sanction. In particular, we suggest that fines linked to the audit or regulatory fee for the case in question or, alternatively, linked to the turnover/profit of the audit business segment of the firm should be properly analysed and considered because they are closer to the current approach of the RSBs in audit cases and the FSA in sanctions applying to firms within its jurisdiction.

A range of appropriate sanctions

- The paper also does not adequately explore other non-financial sanctions that may provide a broader and more appropriate sanctions framework better reflecting the nature of the audit business being undertaken and the wider context in which the accountancy profession operates and which support the maintenance of professional standards and behaviour. For example, enabling Tribunals to employ sanctions that go to education and re-training; supervision or enhanced supervision; the use of enforceable undertakings; the temporary prohibition on taking new clients or engagements. These types of sanction are, we believe, available to comparable regulators and, we suggest, should also be considered by AADB.

RESPONSES TO SPECIFIC QUESTIONS

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

14. ICAEW has for many years published guidance on sentencing for its disciplinary tribunals. We, therefore, agree that providing indicative sanctions guidance to AADB Tribunals to determine an appropriate sanction in cases where misconduct has been proved is a welcome initiative. However, whilst we support the broader objective, we have a number of reservations about the proposed approach to fines, in particular, which we set out elsewhere.

Question 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?

15. A clear framework is sensible. But it does not need to be the same framework for different disciplinary regimes. In relation to fines, the proposed guidance appears to be heavily influenced by the approach of the FSA in its penalty-setting regime set out in its Decision Procedure and Penalties Manual [DEPP]. The FSA's approach is based on three principles:

- Disgorgement so that the firm or individual should not benefit from the misconduct;
- Discipline so that wrongdoing is penalised; and
- Deterrence to deter the relevant firm or individual and others from committing further or similar misconduct.

16. A financial penalty will often be made up of a disgorgement of the benefit received as a result of the breach and a financial penalty reflecting its seriousness. However, the FSA is primarily concerned with consumer and market protection and its enforcement and penalties regime focus on these areas, for example where there has been widespread consumer detriment caused by the mis-selling of a financial services product. So, whilst the FSA may use revenue as an appropriate indicator of the harm or potential harm that a firm's breach may cause, it will also take into account where the firm carries out a redress programme to compensate those who have suffered loss as a result of the breach, or where a redress programme is imposed by the FSA. Further, whilst the FSA will often determine a figure based on a percentage of the firm's relevant revenue, this will often be the revenue derived by the firm during the period of

the breach from the product or business areas to which the breach relates and not the entire group turnover of the firm.

Question 3
Do you agree that the sanctions imposed by the 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?

17. We agree that sanctions should be proportionate to the seriousness of the misconduct in all the circumstances of the case including financial means and the ability to pay is a highly relevant consideration. However, as we have said elsewhere, we have strong reservations about the approach of directly linking a fine to the turnover or income of the Member Firm or Member. Whilst we also agree that sanctions should seek to deter future misconduct, the nature of the misconduct being considered by the AADB Tribunal is unlikely to be wilful or reckless.

18. Our understanding is that the sanctions guidance once made will have retrospective impact rather than just applying to cases referred after the guidance is introduced. We are unsure how a fine in these cases will factor in deterrence in the particular case given that the penalty will relate to past misconduct.

19. Paragraph 3.20 of the paper says that under the Accountancy Scheme a Member Firm cannot avoid liability to investigation and disciplinary proceedings as a result of the conduct of a partner, director or employee acting with actual or ostensible authority, notwithstanding that the Member Firm has established and operated appropriate working practices and procedures. This imposes almost strict liability on Member Firms and is akin to the liability imposed in HSE prosecutions and in anti-corruption cases. This appears to conflict with the rules of attribution set out in cases such as *Tesco Supermarkets Limited v Nattrass*[1] *and Meridian Global Funds Management Asia Limited v The Securities Commission*[2]. We suggest that consideration of this is given in the forthcoming review of the Accountancy Scheme.

20. We have set out elsewhere our concerns about (1) the lack of clarity and certainty about how fines will be calculated and how group turnover will be calculated by the Tribunals; (2) the potential for wildly fluctuating outcomes for similar failings, and (3) the impact of significantly increased fines including on the structure of audit businesses, the recruitment of non-executives and corporate governance and membership of the RSBs.

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

21. We generally agree the factors to be taken into account. There is reference to discount for early admission or early settlement. The guidance is silent on the mechanism for early settlement although this has been included in the changes to the Accountancy Scheme which is the subject of a separate consultation. Generally, we support the resolution of cases at an early stage in order to avoid costly and protracted hearings provided the settlement procedure is transparent. There must be no hint or suggestion of deals being struck in private. We will comment further on arrangements for early settlement in our response to the Accountancy Scheme consultation.

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[1] [1972] AC 153
[2] (New Zealand) UKPC 5 (26 June 1995)

22. The decision making process also refers to sanctions relating to exclusion, withdrawal or ineligibility for a licence, registration or practising certificate. These are regulatory sanctions and, in practice, are likely to have been considered at an earlier stage by the relevant accountancy body acting as an RSB. The risk here is that AADB and the accountancy body are played off against each other where, for example, a firm argues that a regulatory sanction proposed by the accountancy body should not be addressed other than following investigation by AADB. The role of the accountancy bodies to pursue regulatory action should not be prejudiced or fettered by sanctions or powers (including interim orders) that may be available to AADB.

Question 5

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

23. There is no reference to personal mitigating factors in the context of firms. For example, the firm's ability to pay if its financial position is difficult.

Question 6

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

24. There appears to be some consensus that the level of fines in AADB cases has historically been relatively low but, as we have said elsewhere, we believe that the impact of significantly increased levels of fines will have a disproportionate impact in the areas we have highlighted. The AADB should consider these issues and also consider alternative mechanisms for calculating fines – in particular the linking of fines to the audit or regulatory fee in question or the profit of the audit segment of the business responsible for the failing(s).

Question 7

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

25. Essentially, each case is different and the outcome in terms of finding and sanction will depend on the circumstances of that case. There should be a proper consideration of alternative mechanisms for calculating fines rather than focusing solely on the link to turnover/income. Issues relating to the appropriate level of fine were argued at some length in the JP Morgan case where an argument was advanced that the Tribunal should impose a penalty which related to the profits of the auditor (resulting in a figure of £44m). Alternatively, that the fine should be £6m or based on the range of penalties in the ICAEW sentencing guidance and the decisions of the JDS tribunal, that the fine should be between £500,000 and £1m. These arguments were rejected and the Tribunal decided that an appropriate starting point for determining the fine was £2m and actually imposed a fine of £1.4m on the firm after taking into account all the circumstances, including mitigating factors.

Question 8

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

Question 9

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

26. We have grouped these two questions together. As we have said, we do not agree that linking the level of a fine to the group turnover of the Member Firm or the income of the Member is an appropriate mechanism. Whilst the firm's resources and the individual Member's income are factors to bear in mind in considering the overall effect of the penalty we reject the link to the group turnover/individual remuneration. Ability to pay should be factored into decision taking once the "in principle" decision as to the level of fine has been arrived at.

27. The paper says (paragraph 32) that the amount of revenue generated by a firm is relevant in terms of the size of the fine necessary to act as a credible deterrent. In our view this exaggerates the deterrent effect of the fine compared with the other factors to be considered and as set out in paragraph 31 of the paper. In particular, the financial benefit derived or intended to be derived from the misconduct as well as the other factors listed which go to the assessment of the seriousness of the misconduct. The cases falling within the scope of the AADB are, generally, likely to involve a lack of due skill, care and diligence rather than wilfulness or recklessness. Whilst, of course, cases involving matters of public interest can involve important matters of public protection and deterrence is important, we suggest that a significant public element is one of several factors to be taken into account by the Tribunal in exercising its discretion with regard to the level of any fine. The relevant principles/factors were stated in *R v Howe & Co (Engineers) Ltd*[3], cited in *R v Balfour Beatty Rail Infrastructure Services Ltd*[4] and rehearsed in the JP Morgan Securities Limited hearing. In the JP Morgan case those relevant principles were said to be:-

- Breaches of the regulatory legislation were particularly serious because they were the foundation of the health and safety of the public. Misconduct by an auditor is also particularly serious if it fails to reveal failures by regulated financial services firms in compliance with rules intended to protect the public from financial harm.

- It is not possible to assert that a fine should stand in any specific relationship with a turnover or net profit of the defendant. Each case must be dealt with according to its own circumstances.

- It may be appropriate to consider how far short the defendant fell of the appropriate standard.

- A breach with a view to profit seriously aggravates the offence.

- The degree of risk and the extent of the danger, specifically whether it is an isolated failure or one continued over a period.

- The defendant's resources and the effect of the fine on its business. These are factors to be borne in mind. The Tribunal will also stand back at the end of the exercise and consider the overall effect of the penalty and the order for costs to be made.

- Prompt admission of responsibility and a timely plea of guilty; steps taken to remedy deficiencies; a good record.

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[3] [1999] Cr App Rep (S) 37
[4] [2006] EWCA Crim 1586

- The objective of the fine should be to achieve public safety and bring that message home to those who manage a corporate defendant and also its shareholders.

- Consistency of fines between one case and another and proportionality between the fine and the gravity of the offence may be difficult to achieve. The circumstances of individual cases are infinitely variable and, in particular, the standing, resources and scope of the work of firms vary very widely.

- A more serious view can be taken of breaches where there is a significant public element. The fact that a risk has by good fortune or otherwise not eventuated or has eventuated with less serious consequences than might have occurred is a relevant factor. This is also true of audit reports and opinions in relation to the regulation of the financial services sector, insofar as protection from avoidable financial risk is concerned.

28. Consequently, in our view, whilst the Member Firm's resources is a relevant factor, it is only one of several. In the JP Morgan case the Tribunal considered that an appropriate starting point for financial penalties in such cases was £2m. But insofar as the level of fine is to be expressly linked to the firm's means we suggest it would be more relevant and appropriate to use the audit or statutory reporting fee as a starting point. An alternative basis would be the revenues arising from the relevant misconduct as generated by that part of the firm's business. Even so, this should be applied flexibly as in specific cases this may not be appropriate or may require some modification.

Question 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?

29. We agree that costs should not be taken into account in the initial consideration of the level of a fine. But the ability to pay the fine and costs should be considered in the round. As the Tribunal said in the JP Morgan case the costs payable are relevant when considering the overall effect of the penalty and costs on the firm's resources and its business.

Question 11

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

30. Additional points on the Preliminary Impact Assessment and the Guidance in Appendix A of the paper and generally:-

- Paragraph 5.10. The FSA does use revenue as a basis for calculating fines but, as previously stated, on a very different basis from that proposed in the paper. Further, the FSA is considering the primary liability of the regulated financial services firm rather than the secondary liability of the auditor.

- Paragraph 5.12. Whilst the concern about restructuring may be well founded it arises in this context because of the proposed mechanism for linking the level of fines to group turnover. That is an artificial basis which may artificially inflate the level of fines.

- Paragraph 36. The Tribunal should take account of the impact on the firm and individuals within the firm and whether the fine would seriously impact on remuneration or partnership share. The previously stated reputational damage occasioned by adverse findings has potentially serious consequences for the firm.

- Paragraph 37. We suggest that the guidance could generally be clearer about the link between civil liability, compensation paid, fees returned and the fine imposed. In particular, how all these factors may be relevant in mitigating the level of a fine.

- Paragraph 48. Under mitigating factors there is nothing expressly linking compensation paid to fines.

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