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Private and confidential
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Dear Ms Colban

Accountancy and Actuarial Discipline Board – Response to Consultation on Disciplinary Schemes Proposed Changes

INTRODUCTION

1. Ernst & Young LLP welcomes the opportunity to comment on the consultation paper Disciplinary Schemes Proposed Changes (Consultation) issued by the Financial Reporting Council (FRC).

2. Unless the context suggests otherwise: (i) defined terms used in this letter shall have the same meaning given to them in the Consultation and (ii) our comments apply equally to both the Accountancy and Actuarial Schemes.

3. In a few instances, we reference our responses to FRC/AADB consultations as follows:

   - our response of 11 April 2008 to the AADB's consultation on the review of the Accountancy Scheme (referred to below as the "2008 Response");
   - our response of 11 January 2012 to the Department for Business, Innovation & Skills and the FRC's consultation on proposals to reform the FRC (referred to below as the "FRC Reform Response"); and
   - our response of 12 July 2012 to the AADB's consultation on Sanctions guidance for Tribunals (referred to below as the "Sanctions Response").

SUMMARY

4. We are broadly in favour of the majority of the proposals. We do have a few questions and suggestions for improvements, particularly as regards:

   4.1. governance – in the FRC Reform Response, we said we would be grateful to understand better the ring fencing procedures between oversight, FRRP, and disciplinary. This wish remains. There are a number of further opportunities arising from this Consultation for the FRC to provide clarity about its governance model. For example, it would help to understand the FRC's

governance in relation to its proposals for preliminary enquiries, the role of the Case Management Committee, Tribunal appointments, and delegation of powers to the Chairman of the Conduct Committee;

4.2. the decision to launch an investigation – if the objective is to improve clarity to the Scheme and cases fit for disciplinary proceedings, we believe this proposal should be combined with narrowing the definition of misconduct in line with decisions under the predecessor Joint Disciplinary Scheme and earlier versions of the current Accountancy Scheme. These previous schemes provided that for an act or omission to amount to regulatory breach, such act or omission had to fall *significantly* short of the standard of the reasonable average. Such a revision would give participants greater confidence that the FRC's intention is not to capture any technical breach however insubstantial and of limited consequence;

4.3. settlement - we believe any investigation or proceedings should be capable of settlement at any point without the uncertainty of a referral to the Tribunal;

4.4. costs - we believe that there should be a costs incentive for admissions and costs penalties for a party which unreasonably refuses to settle a matter;

4.5. interim orders – we are not aware of any cases which have been prejudiced by the lack of such a power but appreciate that such circumstances may arise. Given the potential significant harm to a respondent in the event interim relief is wrongly ordered, we believe that the requirements for Interim Orders should be no less onerous than those imposed by the Courts in relation to injunctions. As appears to be contemplated in the proposed revisions to the relevant paragraphs to the Schemes, we also believe that guidance should be issued to Tribunals about their use; and

4.6. powers to compel cooperation – this appears to be a significant extension to the reach of the Executive Counsel and Tribunals. We would be interested to understand the foundation for such a change. Without a clear evidential basis, we do not believe the proposal is reasonable or proportionate.

5. We set out our further observations on these and a few other matters in our specific responses to the questions below. We appreciate the FRC consulting on these matters. It is clearly in all parties' interests for the Scheme and related guidance to be in a form which is well-supported by participants. We hope you will find our comments and suggestions helpful and constructive. If you would find it useful, we would be happy to discuss any of the points we have raised in our response further with you or your colleagues.

6. We assume that this and the other responses will be posted on the FRC's website in due course. For the avoidance of doubt, this letter is not intended to be confidential.

Yours sincerely

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Ernst & Young LLP

ANSWERS TO SPECIFIC QUESTIONS

Question 1

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

7. We have no objection to the FRC making the proposed changes to paragraph 5(8) and 6(8) of the Accountancy Scheme in relation to launching an investigation and scope extensions. We note that the FRC expects that there will continue to be close liaison between the FRC and the professional bodies about situations which may warrant investigation and we encourage the FRC to continue to recognise and make use of the resources and expertise of the professional bodies.

8. As regards the proposal to remove the need for a protocol to be agreed with professional bodies relating to preliminary enquiries (paragraph 5(10)), on the assumption that such enquiries will reduce the number of unwarranted investigations and make meaningful costs savings, we have no objection to the removal of the need for such a protocol to be agreed. However, we would welcome a clearer understanding of their scope and acknowledgement that the Conduct Committee would not sanction and the Executive Counsel would not, in the name of preliminary enquiries, engage in a quasi-investigation. It is inherent to a preliminary enquiry that the Conduct Committee has determined that there is insufficient evidence to determine whether a Member Firm or Member is liable to investigation. Therefore, it would be unreasonable and potentially oppressive for the scope of preliminary enquiries not to be much more confined than the scope of an investigation.

9. We note the confirmation at paragraph 3.8 that preliminary enquiries are separate and distinct from supervisory enquiries. As we noted in our summary above we have previously sought clarification and it remains the case that we would be grateful to understand better the ring fencing procedures between oversight, FRRP, and disciplinary.

10. As regards future amendments to the Scheme (paragraph 18), as stated in the FRC Reform Response, we would have preferred that the FRC was required to obtain the consent, not to be unreasonably withheld, of the professional bodies. However, we recognise that the proposal that the FRC will consult with the professional bodies and provide a dispute resolution mechanism is a pragmatic solution.

Question 2

Are the proposals to conclude cases without the need for a tribunal hearing appropriate (paragraphs 3.12 to 3.13 above)?

11. As we stated in our FRC Reform Response, we are in favour of a summary procedure which:

    11.1. is capable of resolving any matter at any stage, partially or fully, without the uncertainty of a reference to the Tribunal; and

    11.2. provides a costs incentive to settle.

12. We believe there should be greater clarity about how the Executive Counsel's discretion in connection with settlement should be exercised. We note that in exercising the discretion, regard

will be had to public interest. If this is intended to convey that where there is a public interest in the matter, the Executive Counsel's discretion will not be exercised in favour of settlement, we do not understand this. First, we would hope that cases are not taken on where there is limited or no public interest. But even where there is a public interest in an investigation or proceedings, we do not understand why that should preclude the use of a settlement process. Otherwise the Schemes are not consistent with other regulatory regimes where there are a number of recent examples of high-profile serious public interest cases being settled by consent.

13. Given the FRC's revised structure and the role of the Case Management Committee and Conduct Committee, we are unsure why it should be necessary for a proposed settlement relating to Complaints which have been served to be approved by Tribunals. It is worth noting that the FSA, has changed its regime to permit its executive to agree to settle any case without the need for further approvals.

14. As regards costs, we do not agree with the proposed changes to the Schemes at paragraph 7(8)(ii). These changes would result in the costs benefit of admissions being removed, and the inclusion of a new provision that no regard should be had to settlement discussions or proposals or offers in determination of a costs award against Members or Member Firms. We suggest that a party which unreasonably refuses to settle a matter at any stage should face a costs sanction. This would save costs and increase the imperative for getting cases resolved in line with the FRC's aim of "effective, proportionate and efficient regulation".

15. In addition, as we stated in our the Sanctions Response, for under-resourced Member Firms or Members, a summary settlement procedure carries the inherent risk of greater pressure to agree to an unfair settlement to save costs and move on. The prospect of a costs recovery if a fair settlement offer is rejected by the FRC would help provide comfort about this risk.

Question 3

Do you agree with the role envisaged for the Case Management Committee (paragraph 3.15)

16. We welcome the proposal that a Case Management Committee assist the Executive Counsel. Clearly the effectiveness of such a Committee largely depends on its membership. We believe that for good governance, independence and to maintain separation of powers, the FRC should ensure that the membership of the Case Management Committee is separate and distinct from the membership of the Tribunal Panel. We would be interested to understand better the FRC's governance model in this connection.

17. We note the proposed role for the Case Management Committee is limited to the point at which a decision to deliver a Formal Complaint is taken and then in relation to consideration of the public interest test and settlement. We suggest that this is extended to include any material amendments to the Complaints given that these can fundamentally change the nature of the proceedings.

18. We suggest a more wide ranging strategic role for the Case Management Committee such that it is consulted at key stages of the prosecution with the aim of providing a check and balance against the risk of disproportionate or overblown prosecution of cases.

Question 4

Are the proposals to facilitate timely completion of investigations and disciplinary proceedings appropriate (paragraphs 3.16 to 3.18)

19. Yes, we believe these proposed changes are reasonable and pragmatic provided that it is accepted and reflected in the Schemes that the Executive Counsel shall act reasonably in exercising his absolute discretion to extend time for representations

Question 5

Should the Executive Counsel be able to seek an interim order against a member or member firm? If so, are the proposed provisions (paragraph 3.19) appropriate?

20. Whilst we are not aware of any cases which have been prejudiced by the lack of availability of a power to make an interim order, we appreciate that there are extreme and infrequent circumstances where such an order may be needed.

21. We note that the consequences of such an order are likely to be severe for defendants. It will be widely assumed, prior to the conclusion of due process, that the defendant is guilty and the defendant will be faced with associated serious damage to reputation. Therefore, we believe that there is a need for clarity regarding the limited circumstances in which such a power may be used by Tribunals.

22. We note that guidance appears to be contemplated at paragraph 13(5)(iii) of the revised Schemes. We would welcome consultation on such guidance. Our initial view is that the test for an interim order should be no less onerous than the test required to be met for a party to obtain an injunction and that the Interim Order must not be allowed to remain in place for any longer than is strictly necessary for the protection of the public.

Question 6

Do you have any comments on the proposals to amend the investigation test (paragraphs 3.24-3.29)?

23. We agree with the statement at paragraph 3.25 of the Consultation that there is confusion and uncertainty about the sorts of cases the FRC investigates.

24. We are in favour of the proposed change to the test for launching an investigation so that investigations are only commenced where there are "reasonable grounds for suspecting misconduct".

25. However, this proposal seems to miss a more obvious route to increasing clarity about the cases to be investigated which is to narrow the definition of misconduct so that it does not include immaterial transgressions but is limited to conduct which fall *significantly* short of the conduct reasonably to be expected of accountants.

26. As we stated in our Sanctions Response and 2008 Response, the Scheme's definition of "misconduct" is a departure from the position under case law on previous accountancy scheme rules which provided that for an act or omission to amount to regulatory breach, such act or omission had to fall *significantly* short of the standard of the reasonable average. There is a line of authorities on this including Mayflower, Capital Corporation and Barings which stated that only where there is a significant departure from the standard of conduct reasonably to be expected could a Tribunal be confident that conduct falls sufficiently outside a range of conduct which might be regarded as acceptable practice.

27. We believe that revising the definition of "misconduct" in line with the case law would bring greater clarity regarding the nature of cases which AADB is likely to prosecute and which are properly the subject of disciplinary proceedings. As we said in our Sanctions Response, such greater clarity would enable a more meaningful dialogue regarding the effectiveness of existing and proposed sanctions.

Question 7

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

The Conduct Committee (paragraph 3(1)(v))

28. We note that a new power has been included for the Conduct Committee to delegate powers to the Chairman of the Conduct Committee. The relevant powers relate to the scope of the Executive Counsel's investigation including the addition of new parties to the investigation.

29. We are unclear what the need for this new power is and no mention is made of it in the Consultation. It seems to us a dangerous move in that it removes an element of good governance and engenders autocracy. This is because in respect of the matters delegated, there is a risk that Executive Counsel is accountable only to the Chairman and not the wider committee thus removing a range of challenges to his conduct of the investigation. In addition, there is the risk that the Chairman is unaccountable for his decisions. Therefore, we believe this proposed power should be removed from the Schemes. In addition, we would reiterate our wish for clarity about the FRC's governance model.

Costs post Admissions (paragraph 7(8)(ii))

30. As noted above in our response to question 2, we do not agree with the proposal to amend the provisions relating to costs at paragraph 7(8)(ii) of the Schemes.

31. As regards the criticism of paragraph 7(8)(ii) by the Tribunal in the JP Morgan case, this appears to be directed to the ambiguity as to whether the provision could be said to apply to exclude the costs of a hearing in relation to an agreed statement of facts once the admission has been made. If the FRC removed the need for settlements to be approved by Tribunals, this issue would not arise. However, even if the current requirements for approval are maintained, the problem could be clarified relatively simply, as the Tribunal suggests at paragraph 46 of its judgment, by an amendment to record that the costs relating to the consequential disposal of the Formal Complaint are not costs which relate to the "subject matter of the admission".

Tribunal Appointments (paragraph 9(1))

32. We note that it is intended to amend paragraph 9(1) which provides that the Conduct Committee takes responsibility from an independent convener for maintaining a Tribunal Panel from which Tribunals are appointed by the independent convener. We are concerned that this amendment will erode into existing separation of powers between executive and judiciary and we would welcome clarity about how the FRC's governance model will address this.

Obligation to cooperate (paragraphs 12(1) and 12(2))

33. We note that the proposed revised provisions would require every Former Member or Former or Successor Member Firm to cooperate at all times fully with the Executive Counsel and the Tribunal.

34. The existing obligations of Former Members and Former Member Firms are set out at paragraph 4(7) of the current Scheme. This states that a Former Member or Former Member Firm is liable to investigation for alleged misconduct which took place whilst they were a Member or Member Firm. There is no express power to require cooperation. However, Former Members and Former Member Firms may be inclined to cooperate as failure to do so risks the Executive Counsel proceeding with complaints on the basis of information available independently.

35. The scope of the proposed new requirement to cooperate includes a requirement to provide oral or written explanations which may be relevant to an investigation and to permit inspection and provide copies of any information which may be relevant to an investigation. We also note the new obligation on a Member Firm to use best endeavours to require every "employee" of that Member Firm to cooperate. This will therefore include people who have never been a Member. If "employee" is understood to mean "partner or staff", the Member Firm would have to use best endeavours to ensure all its people cooperate fully with the Executive Counsel and a Tribunal irrespective of whether they have ever been a Member.

36. The effect of this seems to be that any information held in any capacity by (i) any person who has been a Member (it does not matter when or for how long); or (ii) any partner or staff or a Member Firm is able to be called upon by the Executive Counsel or a Tribunal where it is required in relation to an investigation. There is no qualification that the information was received by the person in a capacity which is regulated by FRC.

37. The new cooperation requirements would amount to a substantial change to the Schemes and increase in the powers of the Executive Counsel and Tribunals. The FRC has not put forward any evidence that it would have been unable to prosecute complaints in matters of public interest without these new powers. It is not clear from the Consultation what the need is for these wide-ranging powers.

38. We are concerned that the proposed new powers are potentially oppressive and could be used disproportionately, For example, an insolvency practitioner licensed by another regulator who is not performing a function regulated by the FRC but who is or has been a Member, or who works for a Member Firm, may receive a wide range of information relating to an entity of which he is an officer. It would be unreasonable for the Executive Counsel or a Tribunal to expect that insolvency

practitioner to provide written and oral explanations and disclose all information in his possession to the Executive Counsel or a Tribunal because it is said to be relevant to an investigation.

39. We recognise that the Executive Counsel or a Tribunal should have jurisdiction to compel disclosure of information received by Former Members and Former Member Firms in a capacity regulated by the FRC. This is proportionate and reasonable as such information is obviously more likely to be relevant to an investigation than the much wider class of information contemplated in the new power.

Sanctions

40. We are pleased that the FRC is considering whether there is merit in broadening the range of sanctions available under the Schemes. As we highlighted in our Sanction Response, we are in favour of Tribunals having available a wider toolkit of non-monetary sanctions as such measures are consistent with the primary purpose of sanctions being to protect the public interest, widely used by comparable overseas regulators, and fit well with the aims and objectives of the FRC including its overall objective to seek to ensure that the market has confidence in the quality of corporate governance and standards of professional practice.