Dear Sir/Madam,

Proposed Sanctions Guidelines by the Financial Reporting Council

EY appreciates the opportunity to comment on the proposed Sanctions Guidelines developed by the Financial Reporting Council (FRC) as set out in the Consultation Paper dated March 2019.

We fully support the introduction of the sanctions guidance for the FRC when considering the imposition of sanctions on regulated persons under the Financial Reporting Council Ordinance (CAP 588) (FRCO). We understand that the effect of its implementation in practice is to be observed.

Overall, the proposed Sanctions Guidelines are very comprehensive and helpful. The detailed responses provided in this letter primarily contain our agreement to the proposals and also some suggestions for clarification and fine-tuning purposes (however these are not intended to be construed in any way as disagreements).

Set out below are our detailed responses to the list of questions that are included in the Consultation Paper.

1. **Do you agree with the FRC’s objectives of imposing sanctions as set out in paragraph 10? If not, please state the particular objective(s) that you do not agree with and the reasons for your disagreement.**

   We agree with the objectives of imposing sanctions as set out in paragraph 10. We also agree with the FRC that its primary purpose of imposing sanctions for misconduct is not to punish but to protect the public and the wider public interest.

2. **Do you agree with the FRC’s approach to determining sanctions summarised in paragraph 19? If not, please explain any alternatives you would propose and the reasons therefor.**

   We agree with the FRC’s approach to determining the sanction to be imposed for a misconduct as summarised in paragraph 19.

   We suggest the guidelines further clarify about the principles used to assess the degree of responsibility of each regulated person (e.g. the engagement partner; the quality reviewer; the person responsible for the QC system; and the firm) for the misconduct. In particular, there is no pre-determined position that in every case a sanction should always be applied to all the regulated persons involved. There should be cases where, based on the facts, one or more but not all of the regulated persons are sanctioned. It is also important that the degree of responsibility, if any, of the firm itself vis-a-vis an individual partner, will be critically considered based on case-specific facts.
3. **Have we included the sorts of factors (paragraphs 21 to 24) in the Sanctions Guidelines that you would expect the FRC to consider in assessing the nature and seriousness of the misconduct and determining the sanctions to be imposed? Are there any other factors you believe the FRC should take into account when determining the sanctions to be imposed?**

Whilst noting that the factors included in paragraphs 21 to 24 are very comprehensive, we suggest some refinements:

- Paragraph 22: it should be explicit that fraud committed by the other party is a relevant factor.
- Paragraph 22 (c): examples such as performance related pay and share options are unlikely to be relevant to auditors and therefore may not need to be included.
- Paragraph 22 (c): the guidelines include the financial benefit derived from the misconduct (the amount of profits gained or losses avoided) as a possible factor. We suggest either not to include this or make it clear that if and when profit or loss is being considered as a factor, it has to be critically evaluated in order to determine whether in that particular incident, profit or loss is indeed an appropriate and measurable/verifiable indicator. Moreover, profit or loss may not be measured consistently from firm to firm because of different measuring bases used by different firms.
- Paragraph 22 (d): it mentions the loss of significant sums of money as a factor and includes examples of quantification of loss by reference to the reduction in market value or loss to creditors. These appear to impose an additional liability on the auditor which may go beyond the existing legal requirements.
- Paragraph 22 (e): please refer to our response to question 4.

4. **Do you agree that the sanctions, including a pecuniary penalty, to be imposed by the FRC should act as an effective deterrent and be proportionate to the misconduct and have regard to all the circumstances of the case, including the financial resources of the regulated persons? If not, what would you propose? Please explain your rationale.**

We agree with the FRC that a pecuniary penalty should be used as a deterrent to misconduct rather than as a punishment.

We also agree with the principle that the pecuniary penalty is made proportionate to the misconduct and will take into consideration, as applicable, the principles and factors set out in paragraphs 37 to 38. Nonetheless, we suggest that further clarifications be included in the sanctions guidelines, as follows.

We understand that the inclusion of paragraphs 38(c)-(d) (about size/financial resources and financial strength) is possibly driven by the good intention of avoiding the likely effect of putting a regulated person in financial distress or forcing the closure of his or her business. However, the wording as it stands may give a wrong impression that firms with more financial resources are automatically subject to a bigger amount of pecuniary penalty that is proportionate to their financial resources, rather than being proportionate to the misconduct.

We suggest that the guidelines be clarified along the following lines:

- The pecuniary penalty will be set at a level (within the upper limit) that is proportionate to the misconduct and expected to act as an effective deterrent. The factors set out in paragraph 38(c)-(d) in relation to the size and financial resources are considered only when it is very likely that the regulated person(s) will be in financial jeopardy as a result of the pecuniary penalty. In that situation, the regulated person(s) is invited to provide the relevant information on a voluntary basis to support his or her financial position for consideration.
The FRC will not as a matter of course demand any financial information from the regulated person(s) upfront when considering the amount of the pecuniary penalty.

5. Do you agree with the factors set out in paragraphs 37 to 43 that the FRC will normally take into consideration when determining the amount of a pecuniary penalty? If not, please explain any alternatives you would propose and the reasons therefor.

We agree that the principles set out in paragraph 37 and the factors in paragraph 38 are generally appropriate. We suggest the following clarifications.

Following the rationale stated in our response to question 4, the guidelines should be clear that the factors as set out in paragraphs 38(c)-(d) and paragraphs 39 to 43 are only relevant in circumstances where the regulated person determines that there is a need for providing this information to be considered by the FRC for determining the level of a pecuniary penalty. Given the confidential and sensitive nature of financial information, the regulated person/firm should not be compelled to disclose his or her/its financial position.

We agree with the approach of considering the cooperation demonstrated by the regulated person in paragraphs 57 to 58 as a mitigating factor when determining the sanctions. We suggest the guidelines clarify explicitly that a reasonable defence, such as using experts and legal advisors, will not be considered as uncooperative behaviour.

6. Do you have any other comments on the Sanctions Guidelines that would help the FRC as an independent auditor regulator to protect the investing public and the public interest?

Paragraph 44 rightly points out that the existence of professional indemnity insurance or indemnification by other parties (such as a firm) should not be a ground for increasing a pecuniary penalty. Indeed, one might also argue that the absence of any such arrangements should not be a ground for reducing a pecuniary penalty. Otherwise, individuals might be encouraged not to buy professional indemnity insurance or seek other parties’ indemnification (thinking that in the absence of these arrangements, the pecuniary penalty will be reduced). We therefore suggest amending paragraph 44 to clarify that there is no need to establish whether such arrangements exist because their existence is not a ground for either increasing or reducing the pecuniary penalty.

As a closing remark, we would like to reiterate our strong support for the introduction of the proposed sanctions guidelines.

If you require any clarification of the above comments, please do not hesitate to contact Alden Leung at alden.leung@hk.ey.com.

Yours faithfully,

Ernst & Young

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