



Lloyds Chambers
1 Portsoken Street
London E1 8HZ

Tel: (020) 7702 0888
Fax: (020) 7702 9452

www.hermes.co.uk

European Commission
DG Internal Market and Services
Unit F4 – Auditing/Liability
SPA 2 (JII), 02/085
B-1049 Brussels

Via Email: markt-f4@ec.europa.eu

London, 8 March 2007

Dear Sirs

Consultation on Auditors' Liability

We are writing to give Hermes' views on the European Commission's consultation on "Auditors' Liability and Its Impact on the European Capital Markets".

Hermes is one of the largest pension fund managers in the City of London and is the principal manager of the BT Pension Scheme and the Royal Mail Pension Plan. We are also responding to this consultation on behalf of the British Coal Staff Superannuation Scheme, the BBC Pensions Trust and some 200 other clients. Hermes has approximately €102 billion under management and it advises with respect to a further €25 billion.*

The beneficiaries of our clients' funds are millions of people worldwide who depend on us for at least a part of their financial security in retirement. Hermes takes a close interest in matters of company law and regulation because they set the context for the exercise of our clients' rights as part owners of the companies in which they invest. We seek to safeguard our clients' current rights and also to enhance the transparency and accountability of companies and their directors to their long-term owners.

By enhancing accountability, we hope to improve efficiency by addressing what economists call the agency problem. It is our fundamental belief that companies with concerned and involved shareholders are more likely to achieve superior long-term returns than those without. By helping make company directors accountable to company owners for the decisions they make and the actions that they take, we believe that over time we will encourage better decision-making and greater value creation.

Our activities are therefore intended to benefit our clients, who need long-term real growth to meet their obligations to pension beneficiaries, and to make companies and economies as a whole more efficient.

In pursuit of these aims Hermes supports a flexible regulatory regime which will:

- encourage company accountability;
- encourage responsible corporate ownership by shareholders and fiduciaries;
- ensure independence of those who audit and monitor company performance; and
- ensure the measures used in reporting performance are relevant for owners.

Our brief answers to the specific questions posed by the Commission are set out below. We would note that we are somewhat surprised that the consultation focuses very little on whether, as a matter of principle, there should be a limit on the liability of auditors at all. At the very least, it seems questionable whether a limited liability system is necessary for companies of all sizes. This issue is touched upon at various points; however, the Commission seems to have made up its mind on this crucial issue already without a thorough discussion of potential effects on the quality of auditing.

We have a real concern that addressing liability in isolation will lead to lower quality audit as this amounts to removing one of the drivers of care and diligence. We would strongly argue that no change in liability should be made unless it is accompanied by other changes which will drive audit quality higher.

In addition, we would like to draw particular attention to the fact that a discussion of the liability regime applicable to auditors should not be conducted in a vacuum. We are concerned the debate seems to have been set in a narrow context, thus excluding such important issues as the diversity in audits and company sizes across the EU and differences between the legal frameworks defining the duties of auditors and regulating access to litigation in Member States across the EU. There are very significant differences in the law governing the legal duties owed by the auditors to companies on the one hand and third parties, including current and future shareholders, on the other hand. We would thus question whether an EU wide solution is sensible at this point in time. If an EU level approach is adopted, we would urge the Commission to take into account that the Member States will require a considerable degree of latitude in adopting an EU approach to allow them to adapt it to the specific local circumstances.

Moreover, it should be borne in mind that there has been a thorough debate of many of the important issues in the UK over the last few years which led to the introduction in the 2006 Companies Act of a system that allows contractual limitation of the liability of auditors.

Of the four options presented in the consultation document, we favour the proportionate liability by contract approach. We would note, however, that in the legal and regulatory context of certain Member States other options may be preferable, and as such, the way forward may be to allow Member States to implement a range of approaches.

Finally, we would note that the new UK approach enshrined in the 2006 Companies Act offers a fifth option, namely a contractual approach to limit auditors' liability which could involve either proportionate liability or a cap. As such, there may be a case for monitoring the implementation and application of the new UK system, then considering all five options in the broader context and on that basis taking a view as to whether any action at the EU level is helpful.

We would be delighted to maintain a dialogue with you on this important matter.

Yours faithfully

A handwritten signature in black ink, consisting of a large, stylized 'C' followed by a series of loops and a long horizontal stroke.

Colin Melvin
Chief Executive

A handwritten signature in black ink, featuring a series of horizontal, wavy lines.

Dr. Hans-Christoph Hirt
Associate Director

* Funds under management figures are at 31 December 2006

List of Specific Questions:

Question 1: Do you agree with the analysis of the option of fixing a single monetary cap at EU level?

Yes, a single monetary cap at EU level, i.e. a one-size-fits-all approach, would be unhelpful. Finding an appropriate level would be extremely difficult. Moreover, this approach would not allow Member States and companies to adopt a system that is based on their specific circumstances taking relevant differences into account.

Question 2: Would a cap based on the size of the listed company, as measured by its market capitalisation be appropriate?

No, every company and the regulatory environment it operates in should be considered individually. Audit risk is not necessarily related to the market capitalisation of a company. In other words, there may well be small companies that are difficult to audit and as such carry a higher risk than large caps. As such a cap related to the market capitalisation seems unhelpful.

Question 3: Would a cap based on the audit fees charged to the company be appropriate?

No. This approach could compromise audit quality by setting wrong incentives. Auditors should be adequately remunerated for their work which should involve appropriate resources. Any incentive that makes charging less more attractive whilst increasing the risk that auditors apply less resource to carry out the work may reduce the audit quality.

Question 4: Do agree with the analysis of the option of introduction of the principle of proportionate liability? What are your views on the two ways in which proportionate liability might be introduced?

Yes, we agree with the analysis regarding the principle of proportionate liability. We strongly favour a solution that would allow appropriate solutions through agreements between the company and its auditors - provided there is a requirement that shareholder approval is needed for any such agreement to come into effect - which would be enshrined in contracts rather than shifting the task to courts by providing judges with discretion to award damages. This is of course an important aspect of the system adopted in the new UK Companies Act.

We would note, however, that this solution is not without difficulties. An agreement regarding liability between the company and its auditors - and approved by shareholders - may be difficult to reach and negatively affect the relations between the parties. More importantly, depending on the agreed solution, proportionate liability means in practice that auditors will not know a finite figure at which their liability is capped. As such, it may not provide auditors with much comfort, if there is a realistic possibility of catastrophic claims involving billions of Euros.

Having said this, a proportionate liability system, based on an agreement between the company and its auditors - and approved by shareholders -, seems to be the best approach amongst the four options presented going forward.

We would note, however, that the approach in the new UK Companies Act offers a fifth option, namely a contractual approach to limit auditors' liability which could involve either proportionate liability or a cap - and which also requires shareholder approval. There may be a case for monitoring the implementation and application of the new UK system, then considering all five options in the broader context, before taking a view and action at the EU level. Particularly in the EU context, where the local audit regulation and practice differ significantly, a considerable degree of latitude for both Member States and companies is required to allow adoption of an EU-wide approach to specific local circumstances. As such, if there is to be an EU level approach, there is much to be said for the new UK system.