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STANDARD LIFE INVESTMENTS

The European Commission
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Dear Sirs

CONSULTATION ON CONTROL STRUCTURES IN AUDIT FIRMS AND THEIR CONSEQUENCE ON THE AUDIT MARKET

Standard Life Investments, which is an indirectly wholly owned subsidiary of Standard Life plc, is a major global investor with assets under management of £123.8 billion as at 31 December 2008. A significant proportion of these assets are invested in the securities of European companies that are subject to an annual audit. Therefore, we attach considerable importance to maintaining a sustainable audit market that delivers high quality audits and is otherwise 'fit for purpose'. Accordingly, we are grateful to you for consulting on the controls structures in audit firms and their consequences on the audit market since we believe these aspects have the potential to improve not only the degree of auditor choice available to companies but also, thereby, to improve the prospects for market and financial stability.

To set the scene, we have for several years expressed consistent concerns about the status quo in respect of the audit market. Little has changed in the audit market but there is increased likelihood of significant litigation against auditors in the wake of the current crisis. Therefore, we urge the Commission to move with a greater sense of urgency than hitherto and to provide bold leadership in order to make serious headway towards a sustainable audit market, which would be consistent with maintaining financial stability and strengthening market confidence. It is relevant to note that in the UK statutory provisions have been introduced to enable auditors to limit their liability, subject to shareholder approval, with a view to, inter alia, improving competition and choice in the audit market. Thus far the provisions have been rarely used and have had no impact whatsoever on audit market choice.

Our responses to the questions posed in the Working Paper are set out below.

Q1.	*Do you see a need for opening up the market for the audit of international companies in order to have more European-wide audit service providers compared to the existing situation? Do we need a more integrated audit market? If yes, why?*

Yes, on both counts. In our opinion, the current situation is not sustainable. Some commentators suggest that the presence of the 'plus 2' auditing networks provides adequate competition but, in our experience of speaking to issuers, although one or other of the 'plus 2' networks are included in the tendering process, they rarely provide serious competition to the

Big 4 networks. We should emphasise that, from our standpoint, based on discussions with senior members of the 'plus 2' networks, they do appear to have the capability to service successfully international clients but regrettably perceptions and reputations tend to work against them.

As noted in the Working Paper, there is concentration in certain sectors, most noticeably the financial services sector in the UK. These concentrations are fundamentally unwelcome, and provide potentially for systematic risk.

The concerns have a global dimension. Europe is well-positioned to take a constructive lead in addressing them. Ideally, it would be useful if the EC worked closely with the SEC to develop a joint European/US solution.

Q2.	*Do you believe that the current number and structures of the audit firms' networks are sufficient?*

No. The current number of audit firms' networks is arguably satisfactory in form but the perceived substance of the 'plus 2' auditing networks and of those on the next level means that in practice there is insufficient choice for the larger global companies.

We don't know enough about the structures of the audit firms to comment about them but we are disappointed that the smaller networks do not appear to have taken a more aggressive approach to developing their franchises (without impairing audit quality). Perhaps they need express encouragement and, possibly, an inducement from the Commission to make this happen. We are not convinced that market forces of themselves will deliver a timely solution.

We note that in the 1970s and early 1980s, the market was characterised as the 'Big 8 plus 2' auditors. To our mind, this was a genuinely competitive market environment. Perhaps the Commission should be more explicit than it has hitherto been regarding what would be the desired outcome in terms of what would constitute a competitive audit market.

Q3.	*Is access to financial capital a key factor to accelerate further integration of audit firms and emergence of new players? Do you share the view that allowing for competing models will create the opportunity for more investments resulting in more global players? Are other models conceivable?*
Q4.	*Would models other than the current one negatively affect auditors' independence? Is there a need for additional safeguards at European level to protect independence? If so, what safeguards should be strengthened?*

We believe that access to capital - or rather lack of it - is a perceived inhibiter to the emergence of new significant players capable of providing a credible global audit service. Also, a natural desire to retain a partnership ethos amongst the firm's partners is perceived as an inhibiter in this context. Hence, removing structural barriers to enable access to capital is a pre-requisite to achieving progress but it will make little difference unless it is done in tandem with the development of models that are compatible with preserving and protecting - or even enhancing - the partnership ethos.

We suggest that models that would hinder rather than help progress would be those that would provide the possibility of too great a concentration of voting power with any one investor. Hence, we strongly commend the development of models that restrict investment by any one investors (and related parties) to not more than, say, 10% of the voting rights.

It is probably best that the Commission is not prescriptive in terms of defining the different types of capital but it might be useful for it to include in any future pronouncement an illustrative list of possible types of capital that can be used in order to ensure that those firms considering capital raising do not feel inappropriately constrained and are, by implication, encouraged to tailor the capital instruments and capital structure to their particular requirements.

With regard to safeguards, the Commission should consider whether the processes of the professional licensing and oversight bodies in Member States need to be strengthened in order to ensure that there is an effective safe harbour if one of their professional members who is a partner in the firm and feels that his or her professional independence is under threat as a consequence, in whole or in part, of ownership and funding arrangements. It is very important that such professionals can raise these concerns with their professional bodies in order that the concerns can be evaluated, escalated and addressed in an appropriate manner.

Q5.	*Should the Commission examine other catalysts accelerating access to the international audit market? If so, which one and why?*

Yes. Time is not on the Commission's side. There is a strong public interest, as we see it, in facing up to the facts and making serious and meaningful headway to address the status quo. One catalyst is to improve the substance of the explanation provided by a board when recommending the re-appointment of the auditor. Currently, most explanations that we see are boilerplate in nature. Also, the Commission should encourage boards and/or their audit committees to disclose when and how periodic formal evaluations of the internal and external auditors were undertaken and of the key conclusions arising there from. This, of itself, will help to inject some catalytic grit into the process.

Also, the Commission should reflect whether, on balance, it is appropriate for Member States to offer fiscal or other financial inducements designed to increase the speed with which change occurs. For example, it might be in the public interest to offer tax breaks or tax deferment to partners in firms that have outside capital over a certain threshold proportionate level.

To help induce investors, the Commission may wish to explore with leading European stock markets whether a specially regulated market - possibly over the counter - for auditor capital and shares could be developed in order to provide liquidity, on the one hand, but ensure the integrity and standing of the beneficial owner, on the other hand.

Finally, the Commission may wish to consider whether it would be beneficial to articulate a negative incentive whereby it would make clear its intention to intervene to break-up the existing firms into smaller components, if market forces fail to find a satisfactory solution.

Q6.	*Are current partnership forms of ownership indispensable in order to recruit, retain and further develop human capital? Could alternative structures under revised control rules allow audit firms to retain human capital and preserve audit quality?*
Q7.	*Is human capital a factor more important than financial capital to expand internationally? Do you see in the current regulation for the audit profession any obstacles related to human capital preventing further integration of audit firms?*

In our view, partnership structures are dispensable but the partnership ethos is less so. We recognise and respect the professional benefits that can accrue to all concerned from maintaining a partnership ethos amongst Europe's leading audit firms.

As investors, it is difficult for us to judge if human capital is more important than financial capital to expand internationally. However, we would note that the two types of capital are not mutually exclusive and can be complimentary catalysts to making progress.

Conclusion

Choice and ownership in the audit firm market has been debated for over a decade. The structural situation and the inherent risks thereof remain unacceptable. Market forces have failed to deliver a meaningful solution. Therefore, we should like the Commission to develop and progress solutions with alacrity, in such a way that confidence in the audit market is strengthened.

Bearing in mind the strong, albeit sometimes latent, public interest in this matter, we suggest the Commission has a responsibility to provide bold leadership to break the global gridlock and to prepare the ground for a more competitive and less concentrated audit market, recognising that some financial inducements may be a pre-requisite to achieving change.

We hope the views expressed in this letter will help inform your on-going deliberations.

Yours sincerely

Guy R Jubb
Investment Director, Head of Corporate Governance
Standard Life Investments