THE FINANCIAL REPORTING COUNCIL

IN THE MATTER OF:

THE EXECUTIVE COUNSEL TO THE FRC **Complainant**

AND

(1) KPMG AUDIT PLC

(2) RICHARD HINTON **Respondents**

DECISION OF THE DISCIPLINARY TRIBUNAL

Introduction

1. This is the decision of the Disciplinary Tribunal, consisting of the Right Honourable Sir Stanley Burnton (legal chair), Mr J Gordon Jack (accountant) and Tania Brisby (lay member) appointed under paragraph 9(2) of the Accountancy Scheme effective from 8 December 2014 ("the Scheme") of the Financial Reporting Council ("the FRC") to hear the Formal Complaint of the Executive Counsel to the FRC against KPMG Audit Plc ("KPMG") and Richard Hinton relating to KPMG's CASS audit of The Bank of New York Mellon London Branch and The Bank of New York Mellon (International) Ltd. for 2011.

2. The hearing of the Formal Complaint took place on 21, 22 and 23 May 2019. KPMG and Mr Hinton (together "the Respondents") admitted the allegations of Misconduct in the Formal Complaint. In consequence, the hearing addressed only the issue of sanctions. The Executive Counsel was represented by Raymond Cox QC and Rupert Allen, instructed by the FRC Legal Team. The Respondents were represented by Bankim Thanki QC and James Cutress QC, instructed by Freshfields Bruckhaus Deringer LLP ("Freshfields").

The Background

3. The Bank of New York Mellon London Branch ("MLB") and The Bank of New York Mellon (International) Limited ("MIL") are part of The Bank of New York Mellon Group ("the BNY Mellon Group"). We shall refer to MLB and MIL together as "the Banks".

4. The BNY Mellon Group is the world's largest global custody bank by the value of custody assets that it holds. MLB is the registered London branch of The Bank of New York Mellon Corporation, a corporation incorporated in Delaware, USA, and which has its principal place of business in New York, USA. MIL is a company registered in the UK.

5. At the time of the Final Notice (as defined at paragraph 42 below), MLB and MIL were (respectively) the third and eighth largest custodians in the UK and together they provided safe custody services to 6,089 clients in the UK. During the financial year ended 31 December 2011, MLB and MIL in relation to their UK business had custody of client assets valued at their peak at approximately £926 billion and £108 billion respectively: a total of over a trillion pounds sterling.

6. At the times material to this Decision, both of the Banks were regulated by the Financial Services Authority ("the FSA", now the Financial Conduct Authority ("the FCA")) in relation to their activities in the UK.

7. KPMG was and is a member firm of the Institute of Chartered Accountants in England and Wales ("the ICAEW"). Mr Hinton is now a partner of KPMG. At the times material to the Formal Complaint he was a director of the firm. He was and is a member of the ICAEW. By virtue of their membership of the ICAEW, the Respondents were and are also respectively a Member Firm and a Member for the purposes of the Scheme. In addition, Mr Hinton was a professional accountant within the meaning of the Code of Ethics of the ICAEW.

8. At all material times, the Banks were required to comply with the Client Asset Sourcebook ("CASS") published by the FSA.

9. KPMG was instructed to prepare and submit reports ("Client Asset Reports") to the FSA in respect of MIL and MLB for the financial years ending 31 December 2007 to 31 December 2011 concerning their compliance with CASS. KPMG was also the audit firm responsible for the statutory audits, pursuant to the Companies Act 2006, of the financial statements of relevant companies in the BNY Mellon Group, including MIL.

The Requirements of CASS

10. Each of the Banks was in relation to its UK business a "firm" within the meaning of CASS. It is common ground that each of the Banks was required to comply with the custody rules set out in CASS 6, including those in CASS 6.5 as it was at the times in question. The relevant duties of auditors under CASS were set out in SUP 3.10. In CASS, provisions labelled R were Rules; provisions labelled G were Guidance.

11. Under the heading "Records and accounts", CASS 6.5.1 R provided:

> *A firm must keep such records and accounts as necessary to enable it at any time and without delay to distinguish safe custody assets held for one client from safe custody assets held for any other client, and from the firm's own applicable assets.*

12. CASS 6.5.2 R provided:

> *A firm must maintain its records and accounts in a way that ensures their accuracy, and in particular their correspondence to the safe custody assets held for clients.*

13. Under the heading "Reconciliations with external records", CASS 6.5.6 R provided:

> *A firm must conduct on a regular basis, reconciliations between its internal accounts and records and those of any third parties by whom those safe custody assets are held.*

14. The guidance in CASS 6.5.4 G, stressed the importance of internal reconciliations:

6.5.4 G (1) Carrying out internal reconciliations of the safe custody assets held for each client with the safe custody assets held by the firm and third parties is an important step in the discharge of the firm's obligations under CASS 6.5.2 R (Records and accounts) ...

(2) A firm should perform such internal reconciliations:

(a) as often as is necessary; and

(b) as soon as reasonably practicable after the date to which the reconciliation relates;

to ensure the accuracy of the firm's records and accounts.

15. CASS 6.5.7 G provided:

Where a firm deposits safe custody assets belonging to a client with a third party, in complying with the requirements of CASS 6.5.6 R, the firm should seek to ensure that the third party will deliver to the firm a statement as at a date or dates specified by the firm which details the description and amounts of all the safe custody assets credited to the account, and that this statement is delivered in adequate time to allow the firm to carry out the periodic reconciliations required in CASS 6.5.6 R.

16. CASS 6.5.10 R was as follows:

A firm must promptly correct any discrepancies which are revealed in the reconciliations envisaged by this section, and make good, or provide the equivalent of, any unreconciled shortfall for which there are reasonable grounds for concluding that the firm is responsible.

17. CASS 6.5.13 R and 6.5.14 G were as follows:

6.5.13 R A firm must inform the FSA in writing without delay:

(1) if it has not complied with, or is unable, in any material respect, to comply with the requirements in CASS 6.5.1 R, CASS 6.5.2 R or CASS 6.5.6 R; or

(2) if, having carried out a reconciliation, it has not complied with, or is unable, in any material respect, to comply with CASS 6.5.10 R.

6.5.14 G Firms are reminded that the auditor of the firm has to confirm in the report submitted to the FSA under SUP 3.10 (Duties of auditors: notification and report on client assets) that the firm has maintained systems adequate to enable it to comply with the custody rules.

18. SUP 3.10.4 R and 3.10.4A R were headed "Client assets report: content" and provided:

> *3.10.4 R An auditor of a firm must submit a client assets report addressed to the FSA which:*
>
> *(1) (a) states the matters set out in SUP 3.10.5 R; and*
>
> *(b) specifies the matters to which SUP 3.10.9 R and SUP 3.10.9A R refer; or*
>
> *(2) if the firm claims not to hold client money or custody assets, states whether anything has come to the auditor's attention that causes him to believe that the firm held client money or custody assets during the period covered by the report.*
>
> *SUP 3.10.4A R (1) For the purpose of SUP 3.10.4 R (1), an auditor must ensure that the report is prepared in accordance with the terms of a reasonable assurance engagement.*
>
> *(2) For the purpose of SUP 3.10.4 R (2), an auditor must ensure that the report is prepared in accordance with the terms of a limited assurance engagement.*

19. Reasonable assurance engagement and limited assurance engagement were defined in the Glossary of terms in the Auditing Practices Board Standards and Guidance for Auditors issued in 2010:

> *Assurance engagement—An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria (also see Subject matter information). Under the "International Framework for Assurance Engagements" there are two types of assurance engagement a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.*
>
> *Reasonable assurance engagement — The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion.*
>
> *Limited assurance engagement — The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the*

> *circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.*

20. SUP 3.10.5 R, under the heading "Client assets report", was so far as material as follows:

> *Whether in the auditor's opinion*
>
> *(1) the firm has maintained systems adequate to enable it to comply with the custody rules, the collateral rules, the client money rules (except CASS 5.2) and the mandate rules throughout the period;*
>
> *(2) the firm was in compliance with the custody rules, the collateral rules, the client money rules (except CASS 5.2) and the mandate rules, at the date as at which the report has been made.*

21. SUP 3.10.9 R provided:

> *If the client assets report under SUP 3.10.4 R states that one or more of the applicable requirements described in SUP 3.10.5 R (1) to (4) has or have not been met, the auditor must specify in the report each of those requirements and the respects in which it has or they have not been met.*

KPMG's CASS Audit Update

22. In September 2011, KPMG issued an update for Partners/Directors. Under the heading "Audit developments APB Bulletin – audit approach" the first bullet point was:

> *Insolvency mindset on a legal entity view – i.e. anticipate insolvency.*

The Auditing Practices Board Bulletin "Providing Assurance on Client Assets to the Financial Services Authority"

23. In October 2011, the Auditing Practices Board published this Bulletin. It stated that it "(a) Contains all of APB's extant guidance relating to the provision of assurance to the FSA on client assets; and (b) is the material referred to in SUP 3.10.5B G to which the FSA expects CASS auditors to

have regard for reports issued on or after the date of this Bulletin."

Paragraph 9 of the Bulletin stated:

> *9. Experience from the financial crisis also points to the need for firms and CASS auditors to adopt an insolvency mind-set. That is, they should evaluate the firm's client asset procedures and status against a level of stress which presumes that the firm may become insolvent.*

24. Paragraph 16 stated:

> *16. Insolvency law has application to legal entities rather than to businesses of consolidated groups that may encompass a number of legal entities. As insolvency law may not permit the Courts to see through the "corporate veil" of the limited liability of individual legal entities, client asset protection usually needs to be structured in the context of the legal entity that holds those client assets rather than in the context of the business within which that legal entity operates....*

25. Paragraph 166 provided:

> *166. The FSA does not regard materiality as a relevant consideration when determining if a CASS Rule has been breached. If a firm has breached the CASS Rules the FSA expects the CASS auditor to assess the firm's systems in light of the CASS breaches to determine whether to express a qualified or an adverse opinion. Therefore, unless there have been no breaches a Client Assets Report will express either qualified or an adverse opinion. (This contrasts with the norm in financial statement audits which is for audit reports to be unmodified).*

The Banks' records, accounts and reconciliations

26. The BNY Mellon Group structured its client custody business on a group basis. Their systems and controls operated across a number of different legal entities in a number of different jurisdictions without distinguishing between them. The BNY Mellon Group held and maintained two sets of relevant records: (i) the Global Securities Processing ("GSP") platform; and (ii) at an entity level, a list of the clients who had contracted with group entities (including MLB and MIL) and copies of the client contracts. The list of clients and contracts were held by the BNY Mellon Group's legal and compliance team, rather than the individual firms. These records were not

linked to the GSP platform. (There was also a CMS platform; it was the legacy system of the Mellon Banks that had been amalgamated with Bank of New York. The information on that platform did not differ from the GSP so far as the issues before the Tribunal are concerned.)

27. The Group employed Bank of New York Mellon SA/NV ("BNYM SA/NV"), a company incorporated in Belgium, as global sub-custodian. It would deposit client assets with a market-facing Group company or a third-party custodian or directly with a central securities depository.

28. The Banks' records, accounts and reconciliations did not comply with the requirements of CASS because they did not maintain a system to enable each of them to comply with the custody rules. Similarly, because they did not each keep records complying with the custody rules, they did not comply with those rules either at the 2011 year-end or at the date of the KPMG reports to which we refer below. Instead of maintaining systems enabling each of them to comply with the custody rules, the Banks relied upon and used the Group record system, that is, the GSP platform.

29. As found in the Skilled Persons' Report to which we refer below:

> *The GSP and CMS platforms do not currently identify the contracting legal entity holding the client's custody assets. Controls were not routinely performed on an individual legal entity basis, and the firm is not able to produce entity-specific books and records at any time or without delay.*
>
> *From discussions with management, we understand that there is a monthly process whereby assets of the UK-regulated entities are carved out for the purpose of populating the Client Money & Assets Report (CMAR)....*

30. CASS did not prohibit the use of a global platform but it required each of the Banks to keep such records and accounts as were necessary to comply with the requirements of CASS 6.5.1 and 6.5.2.

31. The Executive Counsel does not suggest that the operation of the GSP platform gave rise to co-mingling of custody assets. It did provide details of a client's custody assets and of the ultimate third-party sub-custodian or central securities depository holding those assets. There is no evidence

before the Tribunal to suggest that in the ordinary course of business the operation of the GSP platform gave rise to any delays or difficulties in the return of client assets.

The Respondents' CASS Audit reports

32. KPMG was retained by the Banks to carry out their 2011 CASS audits and to report to the FSA on those audits. Mr Hinton assumed the role of the engagement partner with responsibility for the 2011 CASS Audits, and signed the Client Asset Reports on behalf of KPMG. Mr Hinton had performed the same role in relation to previous CASS audits, but no allegation of Misconduct has been made in respect of them.

33. Mr Hinton, on behalf of KPMG, signed and issued to the FSA a CASS Audit Report in respect of each of the Banks on 30 April 2012. The report in respect of MLB was headed:

> *Assurance report on client assets by the independent auditor to the Financial Services Authority in respect of The Bank of New York Mellon London Branch, FSA Reference Number 122467*

34. The report stated:

> *We report in respect of The Bank of New York Mellon London Branch ("the firm") on the matters set out below for the period started 1 January 2011 and ended 31 December 2011 ("the period").*
>
> *Our report has been prepared as required by SUP 3.10.4 R and is addressed to the Financial Services Authority ("the FSA") in its capacity as regulator of financial services firms under the Financial Services and Markets Act 2000.*
>
> ...
>
> ***Qualified opinion on adequacy of systems in relation to custody assets during the period***
>
> *In our opinion, except for the failures as described in the attached breaches schedule, the firm has maintained systems adequate to enable it to comply with the custody rules throughout the period since the last date at which the report was made.*
>
> ...

> ***Clean opinion on compliance at period end date in relation to custody assets and mandates***
>
> *In our opinion, the firm was in compliance with the custody and mandate rules as at the period end date.*

35. The Breaches Schedule listed 5 matters. For the purposes of this Decision, it is unnecessary to list them all. We give, by way of example, the second breach. It listed "The Firm" as the Identifying Party, and stated:

> *As identified on the firm's breaches register, on twenty occasions during the year, the firm utilised assets belonging to one client to satisfy the obligation of another client, where the client has not given express prior consent. This resulted in breach of CASS 6.4.1 R.*

36. The report in respect of MIL gave a qualified opinion on adequacy of systems in relation to custody assets during the period:

> *In our opinion, except for the failures as described in the attached breaches schedule, the firm has maintained systems adequate to enable it to comply with the custody rules throughout the period since the last date at which a report was made.*

37. The report gave a clean opinion on compliance at period end date:

> *In our opinion, the firm was in compliance with the custody rules as at the period end date.*

38. The report contained a qualified opinion on compliance in relation to client money that is not relevant to this Decision.

39. The Breaches Schedule listed three breaches, the first of which was identical to the second breach in the MLB Schedule.

Subsequent events

40. The FSA conducted a client money and assets risk assessment of the Banks during the second quarter of 2012. The FSA's letter dated 3 July 2012 to the Boards of Directors of each of the Banks stated:

> *Our review established the CASS risk in the firms is higher than is acceptable to the FSA and the findings are in areas where we would have expected a firm of the importance of BNYM in the custody sector to have better controls around.*

> *We have reached these conclusions on the firms CASS risk and issues due to:*
>
> *1. The firms appear not to have control of their contractual arrangements with clients in regard to the provision of custody services;...*

The letter listed other matters of concern, but did not refer to the fact that the record system used by the Banks was on a group, rather than individual company, basis and requested that the Banks undertake a wider CASS review. It contained a large number of action points and required the legal entity boards and the CF10A to complete and to report on the follow up action points within 1 month. (The CF10A was the director or senior manager responsible for CASS.) The letter stated:

> *As this was a limited review we will also expect the firms to undertake a wider review of the CASS framework in the firms to ensure that it is being appropriately applied. ...*

41. The Banks responded to the FSA by letter dated 3 August 2012, stating that they intended "to undertake a wider review of their CASS Framework to ensure it is being appropriately applied and that we are meeting all of our CASS responsibilities".

42. We take the next event in the chronology from the Final Notice dated 14 April 2015 ("the Final Notice") served by the FCA on the Banks:

> *4.33 In October 2012, as part of an on-site risk assessment (including an assessment of the Firms' compliance with CASS), the Authority identified further CASS failings. These failings were set out in a Risk Assessment letter and Risk Mitigation Programme sent to the Firms in February 2013. The review identified "significant failures" in the Firms' CASS regime, including examples which the Firms should have identified and mitigated without the need for the Authority's involvement. The review found that the underlying cause of these failings appeared to be insufficient consideration by the Firms of their UK-specific regulatory obligations in implementing a global, rather than entity-specific, approach to custody asset management.*

43. The Banks instructed KPMG to carry out the wider review promised in the letter of 3 August 2012. KPMG issued a report dated 24 May 2013 entitled

"Regulatory Advisory Services in Relation to CASS Arrangements 'Wider CASS review'". Its findings were summarised in the Final Notice:

> *4.34. In May 2013, the findings of the Firms' external regulatory adviser's Wider CASS Review were reported voluntarily to the Authority. These findings included:*
>
> > *(1) the BNY Mellon Group's global operating model "creates a level of complexity for the Firms in the execution of their respective CASS obligations";*
> >
> > *(2) "the Firms' CASS Governance Framework was limited and requires significant considerable enhancement in order to provide comprehensive and effective governance and operational oversight over the Firms' CASS compliance"; and*
> >
> > *(3) "Based on our assessment of the Firms' CASS related processes and controls that fall within the scope of this Report, we have identified a number of issues which we recommend that management should remediate in order to mitigate CASS related risks".*

44. Subsequently, as set out in the Final Notice:

> *4.35. In June 2013, the Authority required the Firms to provide a Skilled Person's report under section 166 of the Act. The Firms appointed two Skilled Persons concurrently. On 12 August 2013, the Skilled Persons issued their report, which expanded on the issues identified previously by the Authority and the Firms' regulatory advisers in the Wider CASS Review. The findings included:*
>
> > *(1) failure to identify in records and accounts the legal entity with which clients contract (as required by the Custody Rules);*
> >
> > *(2) external reconciliations were only being conducted between the global BNY Mellon Group records and accounts and those of non-affiliate sub-custodians, when they should have been conducted between BNY Mellon Group entities and between BNY Mellon Group entities and non-affiliate sub-custodians;*
> >
> > *(3) in the case of some clients who had contracted with BNYMLB to hold physical custody assets, external reconciliations were only carried out between the BNY Mellon Group's records and accounts and those of non-affiliate sub-custodians and only every 18 to 24 months, rather than (1) on an entity-specific level and (2) every six months;*

(4) as of 28 March 2013, the Firms had no formal procedure to consider funding external reconciliation discrepancies as per CASS 6.5.10R; and

(5) on occasions used clients' assets held in omnibus accounts, without the express prior consent of all clients whose assets were held in those accounts, to settle a transaction before corresponding assets had been received under a covering trade of the relevant client. This resulted in some clients' assets being used without consent to settle other clients' trades.

4.36. The issues identified by the Wider CASS Review and the Skilled Persons' report should have been identified by the Firms at an earlier stage through their own monitoring and review of their custody asset compliance regime, particularly because of the centrality of custody assets to their businesses and the substantial value of custody assets held for clients.

4.37. In April 2014, the Firms notified the Authority of an issue with the Firms' segregation of custody assets, which had not previously been identified

45. The Skilled Persons were Ernst & Young LLP and Simmons & Simmons LLP. We refer to part of the Executive Summary in Section E, the E&Y Report on the Stock Reconciliation Issue:

BNY Mellon London Branch and BNYM International Limited operate as global custodian banks and run their global custody model across the wider operations locations (Manchester, Pittsburgh, Pune, New York, Dublin, Brussels, Luxembourg) on a global basis. The Firms utilise two global custody platforms – GSP and CMS. GSP is the legacy BNY system and CMS is the legacy Mellon system. .... The custody platforms process securities transaction information and data at an individual client account level, however both systems do not record the legal entity providing the custody services. The firm maintains a separate database to map client contracts to legal entities. The database is used as part of the Settled But Short Process for funding shortfalls and for the CMAR reporting processes.

Management has informed us that BNYM's custody platforms, GSP and CMS hold records for 17 BNYM entities, with custody assets valued at US$12.2 trillion across 212,000 client accounts spread across 159 markets.

We have sought to test the reconciliation processes and controls as part of our work to address the matters stated in the Requirement Notice (part 3) through interviews,

walkthroughs and testing underlying documentation and systems for BNYMLB and BNYMIL.

From the work performed, our key messages are as follows:

- *The custody records in GSP and CMS do not separately identify the custody assets held by BNYMIL or BNYMLB.*
- *BNYMIL and BNYMLB do not perform legal entity specific internal and external reconciliation as required by CASS 6.5.4G and CASS 6.5.6R.*
- *No custody external reconciliations are performed between BNYMIL/BNYMLB and BNYM SA/NV.*

46. The Banks' CASS failings were set out in section 5 of the Final Notice. We set it out here:

5.1 Based on the facts and matters described above, the Authority has concluded that the Firms have breached Principle 10 and associated Custody Rules. ...

5.2. Principle 10 requires a firm to arrange adequate protection for clients' assets for which it is responsible. The CASS Rules set out detailed requirements placed on firms to assist in ensuring that such adequate protection is in place for custody assets. The Authority has concluded that the Firms failed to arrange adequate protection for the custody assets for which they were responsible.

5.3. The Firms:

(1) failed to implement adequate organisational arrangements for safeguarding client assets, as a result of the failings set out in this Notice;

(2) maintained records and accounts on a global, rather than entity-specific level and in that respect failed to meet the requirements of CASS 6.5.2R;

(3) failed to conduct external reconciliations between the Firms' records and accounts and those of affiliate group companies which the Firms appointed as sub-custodians. Where the Firms appointed non-affiliate third parties as sub-custodians, they also failed to conduct separate, entity-specific reconciliations with the accounts and records of the non-affiliate third party sub-custodians (instead performing external reconciliations on an enterprise-wide basis only);

(4) failed to have an entity-specific process in place prior to July 2012 to identify reconciliation discrepancies for which the Firms were responsible, as a result of which the Firms

were unable to demonstrate compliance with the requirements of CASS 6.5.10R;

(5) failed to take the necessary steps to ensure that assets from 13 accounts, identified as proprietary assets by the Firms' own records and accounts, which were deposited into client omnibus accounts with certain third parties were identifiable separately to assets belonging to clients in those third-party accounts. This resulted in the comingling of Firm and clients' custody assets;

(6) on occasions used clients' assets held in omnibus accounts, without the express prior consent of all clients whose assets were held in those accounts, to settle a transaction before corresponding assets had been received under a covering trade of the relevant client. This resulted in some clients' assets being used without consent to settle other clients' trades. During most of the Relevant Period, the Firms did not have in place systems and controls that could identify the number of instances of this failure;

(7) failed to implement CASS-specific governance arrangements, such as committees that dealt specifically with CASS issues or accountability matrices for or job descriptions referring to CASS roles and responsibilities, until 2011. Although the Firms had some governance committees that included CASS in their Terms of Reference prior to this date, their consideration of CASS-specific issues was on an ad hoc basis only. This was insufficient given the nature of the Firms' business and the Firms' failure to identify and remedy the issues outlined in this Notice during the Relevant Period;

(8) failed to provide CASS-specific training to employees with operational or oversight responsibility for custody assets until March 2012; and

(9) as a result of failing to comply with the requirements of the Custody Rules, the Firms' CASS resolution packs were inadequate (from 1 October 2012 when the requirement to maintain a CASS resolution pack came into force). CASS resolution packs are important as they can assist an insolvency practitioner in achieving a timely return of custody assets in the event of insolvency.

5.4. The Firms' use of global custody platforms which, during the Relevant Period, did not record with which BNY Mellon Group entity clients had contracted, caused several of the Firms' failings. For example, the Firms' failure to maintain books and records on an entity-specific basis meant that the Firms were unable to fulfil their obligations to:

(1) maintain entity-specific records and accounts, which meant that the Firms' records and accounts failed to meet the requirements of CASS 6.5.2R;

(2) conduct entity-specific reconciliations between the Firms' records and accounts and those of affiliate group companies which the Firms appointed as sub-custodians or to conduct entity-specific external reconciliations with the accounts and records of non-affiliate third party sub-custodians by whom client assets were held (instead performing external reconciliations on an enterprise-wide basis only);

(3) maintain an adequate CASS resolution pack (from 1 October 2012 when the requirement to do so came into force) that would have assisted an insolvency practitioner in achieving a timely return of custody assets in the event of BNYMLB's and/or BNYMIL's insolvency; and

(4) submit accurate Client Money and Assets Returns ("CMAR") from October 2011 (when the requirement to do so came into force) until the end of the Relevant Period.

5.5. As a consequence of these failures, the Authority has concluded that the Firms failed to arrange adequate protection for the custody assets for which they were responsible as required by the Custody Rules.

5.6. Having regard to the issues above, the Authority considers it is appropriate and proportionate in all the circumstances to take disciplinary action against the Firms for their breaches of Principle 10 and associated Custody Rules over the Relevant Period.

47. "The Relevant Period" was defined as the period from 1 November 2007 to 12 August 2013.

48. We also refer to paragraphs 2.4 to 2.9 of the Final Notice:

2.4 An insolvency process is often, by its nature, complex and fast-moving. Many unpredictable issues may unfold that need to be dealt with at short notice in order to ensure minimum impact on consumers. The custody asset regime seeks to ensure that the wind-down of a firm in the event of an insolvency is carried out in as orderly a manner as possible and in a way that reduces the risk of loss of consumers' custody assets. The custody asset regime is designed to ensure protection of custody assets and, to the extent possible, to speed up the return of those assets to clients in the event of firm failure, thereby reducing costs which would be met out of clients' assets. It is also designed to ensure that records in relation to custody assets are reconciled regularly to ensure

their accuracy and enable them to be retrieved promptly while the firm is a going concern as well as when the firm has become a gone concern. For example, accurate, entity-specific records and accounts should be accessible to an Insolvency Practitioner in the event of a custodian's insolvency.

2.5 Compliance with the Custody Rules reduces the extent of the following kinds of loss or delay:

(1) diminution of assets due to costs of the insolvency: where a firm's accounts and records are not compliant with the Custody Rules, the Insolvency Practitioner may need to:

(a) seek directions from the Court in order to return assets to clients;

(b) resolve multiple claims for the same assets from different entities, including those subject to different insolvency regimes;

the costs of which would be borne by the custody asset pool and therefore ultimately by the clients to whom those assets belong;

(2) loss in opportunity to deal with assets: clients lose opportunities to complete pending transactions, to trade on or to realise the value of their assets while they wait for assets to be returned by an appointed Insolvency Practitioner. During the period when clients do not have access to their assets, the value of those assets may fluctuate and if the value decreases a client may therefore lose economic value; and

(3) delay in the return of assets: the Insolvency Practitioner has to identify and go through a process to independently verify for which clients the insolvent entity holds assets and to settle unresolved shortfalls, which process causes delay in the return of assets.

2.6. Compliance with the Custody Rules prior to insolvency can have a mitigating effect in an insolvency process for the reasons given above and is something over which firms have complete control. It is in this context that the Authority views breaches of the Custody Rules, and a firm's failure to comply with those rules, as a particularly serious matter.

2.7. The Firms' use of global custody platforms which, during the Relevant Period, did not record with which Bank of New York Mellon Group ("BNY Mellon Group") entity clients had contracted, caused several of the Firms' failings. Had the Firms complied with the Custody Rules, they would, in the event of the insolvency of BNYMLB and/or BNYMIL at any

point during the Relevant Period, have been able to provide entity-specific accounts and records to the Insolvency Practitioner, which would have provided a record against which the Insolvency Practitioner could compare other information sources held by the Firms. This would have reduced the risks identified in paragraph 2.5 and the complexity in returning assets to customers in an already complex insolvency situation.

2.8. The Firms' failure to maintain books and records on an entity-specific basis meant that the Firms were unable to fulfil their obligations to:

> *(1) maintain entity-specific records and accounts, which meant that the Firms' records and accounts failed to meet the requirements of CASS 6.5.2R;*
>
> *(2) conduct entity-specific reconciliations between the Firms' records and accounts and those of affiliate group companies which the Firms appointed as sub-custodians or to conduct entity-specific external reconciliations with the accounts and records of non-affiliate third party sub-custodians by whom client assets were held (instead performing external reconciliations on an enterprise-wide basis only);*
>
> *(3) maintain an adequate CASS resolution pack (from 1 October 2012 when the requirement to do so came into force) that would have assisted an insolvency practitioner in achieving a timely return of custody assets in the event of BNYMLB's and/or BNYMIL's insolvency; and*
>
> *(4) submit accurate Client Money and Assets Returns ("CMAR") from October 2011 (when the requirement to do so came into force) until the end of the Relevant Period.*

2.9. As a consequence, the Authority has concluded that the Firms failed to arrange adequate protection for the custody assets for which they were responsible as required by the Custody Rules.

49. The FCA considered the Banks' failings to be serious, and imposed a financial penalty of £126 million (discounted from £180 million for settlement). The Tribunal notes that the issues referred to in the FCA's Final Notice, many of which were identified in KPMG's Wider CASS Review report of 24th May 2013, cover a longer period and wider scope than the admitted 2011 CASS audit failings that were the subject of the Formal Complaint against KPMG and Mr. Hinton.

The Admitted Misconduct

50. Misconduct is defined in paragraph 2(1) of the Scheme as:

> *"an act or omission or series of acts or omissions, by a Member or Member Firm in the course of his or its professional activities (including as a partner, member, director, consultant, agent, or employee in or of any organisation or as an individual) or otherwise, which falls significantly short of the standards reasonably to be expected of a Member or Member Firm or has brought, or is likely to bring, discredit to the Member or the Member Firm or to the accountancy profession."*

51. The Allegation of Misconduct in the Formal Complaint is as follows:

> *In relation to the planning, execution and documentation of the 2011 CASS Audits, the conduct of KPMG and Mr Hinton fell significantly short of the standards reasonably to be expected of, respectively, a Member Firm and a Member, in that: (1) they failed to give adequate consideration as to whether the records of custody relationships maintained by the BNY Mellon Group were compliant with the CASS rules (as detailed below) and / or as to the implications for CASS compliance by MLB and MIL of the GSP platform being maintained and operated by the BNY Mellon Group on a global group (rather than individual firm) basis; and as a result (2) failed to undertake sufficient audit procedures to support the opinions set out in the 2011 Client Asset Reports. KPMG and Mr Hinton thereby failed to act diligently and in accordance with applicable technical and professional standards and guidance (including SUP 3.10 and the Bulletin) in accordance with the Fundamental Principle of Professional Competence and Due Care, as set out in paragraphs 100.5(c) and 130 of the Code.*
>
> *1. The Respondents failed to give adequate consideration in the planning and execution of the 2011 CASS Audits to the need to adopt an "insolvency mind-set" and/or to approach the 2011 CASS Audits on an individual firm basis in relation to each of MLB and MIL (as required, in particular, by paragraphs 9, 16, 78-80, and 92 of the Bulletin).*
>
> *2. In particular:*
>
> *a. The Respondents did not plan to test and/or did not test external reconciliations on an individual firm basis, i.e. for MLB and MIL separately (see, for example, working paper F.72 recording the testing of unit trust reconciliations which is identical on both the MLB and MIL CASS audit files);*

b. The Respondents therefore failed to carry out any or adequate procedures (or to document such procedures on the CASS audit files for MLB or MIL) to test whether external reconciliations were being carried out throughout the Relevant Period by MLB and MIL on an individual firm basis with affiliate and/or non-affiliate sub-custodians;

c. The Respondents failed to identify that, while there were sub-custodian relationships between MLB and MIL and affiliate entities within the BNY Mellon Group (as they knew), MLB and MIL had carried out no external reconciliations with those affiliates on an individual firm basis as required by CASS;

d. The Respondents failed to carry out adequate steps to identify that it was not possible to determine from the records kept and maintained by the BNY Mellon Group on the GSP platform which individual firm in the BNY Mellon Group (and in particular MLB and MIL) the client had contracted with for the provision of safe custody services. While the BNY Mellon Group did maintain (separately from the GSP platform) a list of clients and their contracts from which legal relationships with individual firms in the BNY Mellon Group (e.g. MIL or MLB) could, in theory, be identified:

> *i. KPMG did not link their audit work on these matters to their work on the adequacy of the records kept and maintained on the GSP platform so as to ensure that the custody and sub-custody relationships between clients and individual firms in the BNY Mellon Group could without delay or, in some cases, at all be traced through to the records kept and maintained on the GSP platform; and*
>
> *ii. the list of clients and contracts was not in fact sufficient in all cases to enable the custody or sub-custody relationship to be identified and so accordingly they were not, in combination with the records kept and maintained by the BNY Mellon Group on the GSP platform, sufficient to ensure compliance with CASS.*

e. The Respondents failed adequately to document such consideration as they gave to the appropriateness of relying on the findings contained in the SOC 1 Report in support of their conclusions as to MLB's and MIL's compliance with CASS (for instance, the testing of systems and controls in relation to whether MIL and MLB had maintained adequate and accurate accounting records on an individual firm basis in accordance with CASS — see working paper F.80) despite the fact that:

i. the SOC 1 Report had been produced by an affiliate entity in relation to the group-level systems and controls operated by the BNY Mellon Group, and did not examine or test the systems and controls on an individual firm basis, as required by CASS and KPMG's own CASS audit work programme; and

ii the Respondents did not plan to take any or sufficient steps to confirm that each individual firm was operating the same system as had been tested in the SOC 1 report (and did not in fact do so when carrying out the 2011 CASS Audits);

f. The Respondents ought to have adequately documented, in relation to each firm on an individual basis:

i. Why the SOC 1 Report was relevant for the CASS audit of that firm; and

ii. How the SOC 1 Report was going to be used to support the conclusions reached in relation to the CASS audit of that firm.

3. Had the Respondents given adequate consideration in the planning and execution of the 2011 CASS Audits to the need to adopt an "insolvency mind-set" and/or to approach the 2011 CASS Audits on an individual firm basis in relation to each of MLB and MIL, they would or ought reasonably to have identified and reported to the FSA in the 2011 Client Asset Reports that in breach of the CASS rules:

a. It was not possible to determine without delay, or in some cases at all, from the records of custody assets held on behalf of MLB and MIL that were maintained on the GSP platform:

i. which individual firm in the BNY Mellon Group the client had contracted with for the provision of safe custody services, and

ii. the existence of any sub-custodian relationships between MLB and MIL and other companies within the BNY Mellon Group;

b. MLB and MIL were unable to, and did not, carry out external reconciliations with affiliate sub-custodians within the BNY Mellon Group; and

c. MLB and MIL were unable to and did not carry out external reconciliations on an individual firm basis with non-affiliate sub-custodians outside the BNY Mellon Group (as opposed to the external reconciliations that were actually carried out by the BNY Mellon Group at a group/client level

between their records maintained on the GSP platform and the records of non-affiliate sub-custodians).

52. In their Defence, KPMG and Mr Hinton agreed that it was necessary for a CASS audit to be carried out on an individual firm (rather than corporate group) level, and agreed the Allegation. They had admitted the Allegation in KPMG's letter dated 19 December 2017.

The evidence before the Tribunal

53. In addition to the ring binders of contemporaneous documents, subsequent correspondence and authorities the Tribunal had before it the transcript of Mr Hinton's interview with the FRC on 15 April 2016, the witness statement of David Matthews, a partner of KPMG LLP (which is the ultimate controlling entity of KPMG Audit Plc) and the Head of Quality and Risk Management for KPMG LLP and its subsidiaries and expert reports of Jeremy Willmont (instructed by the FRC) and Russell Downs (instructed by KPMG). Mr Willmont and Mr Downs were cross-examined on their Reports.

54. Among the exhibits to Mr Matthews' witness statement was a letter to the Tribunal from Mr Hinton, in which he apologised for the Misconduct. In it he stated:

> *... I do want the Tribunal to know that, when conducting the 2011 CASS audits, I genuinely believed that – aside from the breaches identified in the 2011 Client Asset Reports – BNYM was operating a custody model which complied with the FSA's requirements. None of the training I had received or the guidance I had read prior to completing the 2011 Client Asset Reports led me to conclude that a custody model which did not conduct reconciliations on the legal entity basis would be in breach of the CASS rules....*
>
> *With hindsight I accept that, although my beliefs at the time were honestly held, this was an error and that I ought to have concluded that the BNYM model was non-compliant. I deeply regret this error. ...*
>
> *I am also deeply concerned that any publicity and sanction resulting from the breaches I have admitted will cause me yet further personal and professional damage. As Mr Matthews also notes in his statement, my concern about the impact of*

this case has already been such that I felt compelled to transfer to a new role in KPMG's tax technology practice. ...

The fact that these breaches have essentially had a terminal effect on [my career in financial services audit] has not only caused me a great deal of personal distress, but also served to emphasise for me the severity of the consequences of failing to maintain the highest technical standards. I have never previously been involved in disciplinary or any other form of proceedings in any capacity and will take every possible precaution to ensure that I am never in this position again.

55. Mr Matthews gave evidence under 8 headings:

(a) KPMG's commitment to continuously improving the quality of its audit practice;

(b) The comprehensive training offered by KPMG to CASS auditors carrying out CASS audits for the financial year ending 31 December 2018;

(c) The key enhancements KPMG has made to its CASS training and audit work programmes since the financial year ended 31 December 2011;

(d) KPMG Audit's financial resources and insurance cover;

(e) KPMG's disciplinary record;

(f) Mr Hinton's disciplinary record;

(g) The impact of these proceedings on Mr Hinton; and

(h) Other factors that I [Mr Matthews] understand are relevant to the Tribunal's decision on sanction.

56. Under heading (a), Mr Matthews stated that KPMG had been heavily involved in defining what should be best practice in CASS audits. He described KPMG's Audit Quality Transformation Programme "which consists of a wide range of initiatives designed with the aim of developing and implementing an improvement culture that ensures that the highest standards of consistency and rigour are applied across all of KPMG's audits." In addition, KPMG has established a new three-day off-site training programme, called the KPMG Audit University that "seeks to ensure that all KPMG's auditors are fully up-to-date with recent audit development, and clear on the fundamental principles of the KPMG audit." "The KPMG Audit University is mandatory for all statutory auditors with two years or more of experience. Attendance is also highly recommended

for the Financial Services Assurances Services Banking team (which includes KPMG's Banking CASS subject matter experts)." The projected external cost of the KPMG Audit University is £3 million per year, in addition to a substantial investment of internal time.

57. Under heading (b), Mr Matthews gave extensive evidence of KPMG's current training for CASS auditors, which includes classroom training sessions and an e-learning module. Under heading (c) he set out significant enhancements to KPMG's training and work programmes. At paragraph 30 of his statement, he said:

> *30. Following the introduction of the FRC Client Assets Assurance Standard, in October 2016 KPMG changed the way in which risk assessments were conducted in respect of CASS audits. KPMG now centrally allocates accredited CASS Engagement Quality Control Reviewers (ECQRs) [sic](technical reviewers) to all CASS audits (i.e. both reasonable and limited assurance audits). This is an enhancement to the FRC's Client Assets Assurance Standard, which only requires EQCRs to be appointed on reasonable assurance audits.*

In addition, Mr Matthews stated:

> *39. KPMG's full-day and half-day classroom training sessions contain reminders from the 2015, 2016 and 2017 training materials that insolvencies are legal entity specific and that CASS applies at the entity level.*
>
> *40. In contrast, the training provided for CASS auditors working on CASS audits for the financial year ended 2011 did not include any specific references to this principle.*
>
> *41. The APs have also been enhanced to address the concept of legal entity specificity. For example, the APs used for CASS audits for the financial year ending 31 December 2018 include "Exec Summary" tabs highlighting key risks for auditors, including the application of CASS rules on a legal entity specific basis (specifically, the guidance states that "CASS applies on a legal entity basis, i.e. to the firm in its own right"). In addition, the Governance AP contains a specific tab covering legal entity procedures.*
>
> *42. As explained above, KPMG's training and work programmes have developed significantly since 2011, the time at which Mr Hinton led the CASS audits which are the subject of these proceedings.*

> *43. KPMG accepts that the training and support provided to Mr Hinton did not, with hindsight, adequately draw attention to the principal issue in this case, namely the concept of legal entity specificity. KPMG accepts that Mr Hinton could expect to rely on the technical support given by the firm in relation to such matters and that, at the time, such guidance in the APs or in other internal guidance did not identify as explicitly as is now the case importance of considering legal entity specificity.*

58. The Appendix to Mr Matthews' witness statement gave more extensive details of KPMG's 2018 training for CASS auditors.

59. Mr Matthews' evidence was supplemented by the information in Freshfields' letters to the FRC. In Freshfields' letter dated 29 April 2019 details were given of KPMG's substantial involvement in defining what should be best practice in CASS audits. Freshfields' letter dated 9 May 2019 gave details of KPMG's improvements in its CASS audits. That information was enlarged upon in Freshfields' letter dated 20 May 2019:

> *Through a combination of the changed regulatory landscape and the significant enhancements of KPMG's internal training environment..., and through the review processes that KPMG operates in connection with its CASS practice, KPMG is confident that its current systems and controls environment in relation to CASS audit quality is sufficiently robust:*
>
> *i. KPMG complies with the Standard by appointing engagement quality control reviewers (known internally at KPMG as Technical Reviewers) for all reasonable assurance and hybrid CASS audit opinions. Technical Reviewers are required to review all working papers that record any significant judgments and all relevant Audit Programmes. They must be CASS Subject Matter Experts and must have an appropriate level of CASS experience for the type of opinion being signed and the level of risk identified. Technical Reviewers receive ongoing support from the central CASS Audit Quality Team (including regular calls with circulated minutes during busy season, Risk Alerts and email bulletins as appropriate). The designation of an individual as Technical Reviewer is determined by the type of opinion and the level of risk related to the engagement, rather than the grade of the individual. Only the most experienced Technical Reviewers are allocated to engagements categorised as "Significantly High Risk".*

> *ii. Further, KPMG operates a more rigorous review process than that which is mandated by the Standard by appointing a Technical Reviewer on every limited assurance opinion as well as on the reasonable assurance and hybrid opinions.*
>
> *iii. KPMG additionally appoints a partner to conduct a quality control review on engagements categorised as "Significantly High Risk" (i.e. CASS audits of the largest and most complex clients) (the Partner EQCR). That appointment requires a partner to commit between one and three weeks of full-time work per engagement.*

60. Under heading (d) Mr Matthews set out figures for KPMG LLP's UK revenue and operating profit or loss in the years 2016 and 2017. For present purposes it is sufficient to note that the total operating profit for all KPMG UK entities from audit and directly related services was £55 million in 2016 and £43 million on 2017. There is no evidence before the Tribunal that these profits have diminished substantially since 2017. KPMG accepts that for the purposes of assessing any financial sanction it is the resources of KPMG LLP that should be taken into account, rather than those of KPMG Audit alone. KPMG is not insured in respect of any sanction the Tribunal may impose. It will indemnify Mr Hinton in respect of any fine imposed on him, but it is common ground that this should not, and it will not, affect the amount of the fine the Tribunal considers appropriate.

61. In paragraphs 48 to 58 of his witness statement, Mr Matthews addressed what the Executive Counsel, in her written submissions, described as KPMG's "very poor disciplinary record". As at 20 November 2018, the date of Mr Matthews' witness statement, it comprised 4 adverse Tribunal decisions. They related to audits of Cable & Wireless Worldwide plc (CWW), Pendragon plc, Quindell plc and Ted Baker plc. The decisions in *CWW* and *Pendragon* were issued in January 2015, and concerned audit independence issues. KPMG admitted Misconduct in both of these cases, The Tribunal imposed a fine of £350,000 (adjusted to £227,500 on account of the admission) and a Reprimand on KPMG in the CWW case. In the Pendragon case a fine of £250,000 (adjusted to £162,500 to reflect the admission) and a Reprimand were imposed on KPMG.

62. In the *Quindell* case, KPMG and its partner admitted Misconduct in relation to revenue recognition for legal services and a series of transactions for the sale and purchase of software licences and related services and investment. The Misconduct consisted of a failure to obtain reasonable assurance that the financial statements as a whole were free from material misstatements, a failure to obtain sufficient appropriate audit evidence and a failure to exercise sufficient professional scepticism. Following a settlement, in June 2018 the Tribunal imposed on KPMG a fine of £4.5 million (reduced to £3.15 million on account of the admission) and a Reprimand.

63. The Tribunal's decision in the *Ted Baker* case was issued in August 2018. KPMG and a partner admitted 8 allegations of Misconduct which included allegations relating to audit independence. The Tribunal imposed on KPMG a fine of £3 million, reduced on account of its admission to £2.1 million, and a Severe Reprimand. The partner, Mr Barradell, received a Reprimand and a fine of £80,000, reduced on account of his admissions to £46,800.

64. Since the date of Mr Matthews' witness statement there have been two additional Tribunal decisions concerning KPMG. On 8 May 2019, it was announced that KPMG had admitted Misconduct in relation to the 2009 audit of The Co-operative Bank plc and agreed to pay a Fine of £5 million (reduced for settlement to £4 million) and had accepted a Severe Reprimand and a Condition that all KPMG's audit engagements with credit institutions for years ending 2019 to 2021 would be subjected to an additional review by a separate KPMG Audit Quality team. The engagement partner agreed to a fine of £125,000, reduced to £100,000 on account of the settlement, and accepted a Severe Reprimand. The Misconduct involved, essentially, a failure to challenge management in respect of highly material aspects of the audit.

65. Finally in relation to previous findings of Misconduct, it was announced on 30 April 2019 that a Tribunal had found Misconduct against KPMG in relation to the audits in 2007, 2008 and 2009 of the accounts of Lloyd's Syndicate 218 (Equity Red Star) and the provision of actuarial advice to

Equity Syndicate Management Ltd between 2007 and 2009. The Tribunal imposed a fine of £6 million and a Severe Reprimand.

66. None of these cases concerned CASS audits. They did, however, relate to the quality of KPMG's audit practices.

67. In her written submissions the Executive Counsel challenges Mr Matthews' evidence as to the improvements to KPMG's audit practice:

> *The most recent report of the FRC's Audit Quality Review team ("AQR") on KPMG's audit work indicates that any such alleged improvements have not been effective. The AQR found that just 50% of KPMG's FTSE 350 audits (and 61% of its audits overall) that it inspected between February 2017 and February 2018 required "no more than limited improvements". The report noted: "There is substantially more for the firm to do" to achieve the FRC's target of 90% by 2018/2019. The report concluded: "The overall quality of the audits inspected in the year, and indeed the decline in quality over the past five years, is unacceptable and reflects badly on the action taken by the previous leadership, not just on the performance of front line teams. Our key concern is the extent of challenge of management and exercise of professional scepticism by audit teams, both being critical attributes of an effective audit, and more generally the inconsistent execution of audits within the firm.*

However, the Tribunal was given grounds to think that the latest AQR will be more positive.

68. Mr Matthews also addressed Mr Hinton's disciplinary record and the impact of the proceedings on him. Mr Hinton had no previous disciplinary record. He is a relatively young partner, aged 46. The worry brought about by these proceedings led him to decide to transfer from auditing to KPMG's tax technology practice.

The expert evidence

69. Mr Willmont's and Mr Downs' evidence concerned the administration of the Banks in the event of their insolvency with a view to assisting the Tribunal in assessing the potential impact of the Misconduct as the failure to maintain records and reconciliations on an entity specific as opposed to

global basis, as required by the CASS rules, would not necessarily have any adverse consequences other than in an insolvency. Neither gave evidence as to the effectiveness of the CASS custody rules. In addition to their written reports the Tribunal had the benefit of the very helpful Experts' Joint Statement and, as indicated above, their oral evidence in cross-examination and, in the case of Mr Downs, his re-examination.

70. There was inevitably a high degree of speculation in their evidence. We accept that in practice it was unlikely that the Banks would become insolvent and note that the Banks' primary business activities consisted of the provision of custody services and related agency services. This was a less risky type of investment banking service than the business of Lehman Brothers, the collapse of which influenced the increase in regulatory focus to entity specificity in CASS audits and the speed of return of client assets. The effect of an insolvency cannot, in the Tribunal's view, be confidently predicted. Much may depend on the size and causes of the insolvency. The experts agreed that if there were an insolvency, in all probability all of the companies in the BNYM Group would be affected and be insolvent. A UK liquidator or administrator would be appointed in respect of both of the Banks, although the lead insolvency of MLB would be in the USA. As Mr Cox QC rightly said, the Group is of systemic importance in the global financial system, and its insolvency could potentially have catastrophic consequences.

71. We accept Mr Downs' evidence that the likelihood is that the insolvency practitioners world-wide would seek to cooperate and effect a Group administration rather than one in which each company's insolvency practitioner competed with the others to secure the return of its client's assets. However, each insolvency practitioner would owe duties to the clients of the company to which he was appointed. The GSP platform itself would not be helpful in this regard. The experts agreed the following:

> ***Multiple claims***
>
> *2.10. Insolvency Practitioners appointed over MIL or MLB would have to deal with many claims to assets from claimants*

filing claims in more than one location, as claimants tend to lodge claims wherever possible in order to protect their interests and maximise their recovery prospects.

Sources of information about custody assets

2.11. MIL and MLB maintained records and accounts for custody assets on a global, rather than entity-specific level and used the BNYM Group's GSP system for that purpose. Client details were maintained separately.

2.12. An Insolvency Practitioner appointed over MIL, MLB, or an appointed officeholder to other affiliates such as The Bank of New York Mellon SA/NV ("SA/NV") would be able to ascertain from GSP the position of the BNYM Group as a whole with any non-affiliate sub-custodian or central securities depository, but would not know from GSP what assets each specific BNYM Group entity had transferred to sub-custodians, whether affiliated or non-affiliated, as GSP did not record that information.

2.13. It would also not be possible to identify from GSP itself (a) which clients had contracted with which specific BNYM Group entity, and (b) the identity of any affiliated sub-custodians or the assets for which they were each responsible.

2.14. In order to establish individual positions of specific entities, which JW considers is necessary but RD does not, further information would be required from other sources such as client contracts and information provided by clients themselves. This is discussed below.

Reliability of information and risk management

2.15. In order to return an asset to a client, the Insolvency Practitioner would seek certainty that the asset and the client were correctly identified and matched to each other, or failing that would need to have satisfactory assurances in place to cover potential liability for any error.

2.16. It was agreed that reconciliations between GSP and sub-custodians or central securities depositories were only carried out on a group basis, and that there were no reconciliations carried out on an entity-specific basis, so that any discrepancies identified by the reconciliations were not allocated to specific entities.

72. Entity-specific records and reconciliations, as required by CASS, would enable an insolvency practitioner of the Banks to identify their particular clients and the assets they had deposited with them. The clients of the Banks are generally financial institutions and very high net worth individuals who would be expected to have good records of their own and

who would speedily make their claims for the return of their assets. Against this, however, we note what the experts agreed as set out in paragraph 2.10 above of their joint statement. This emphasises the need for the Banks to have their own entity-specific client records. Furthermore, the Tribunal places considerable weight on the statements in the Final Notice, cited above, as to the potential consequences of the Banks' failures to comply with the CASS custody rules.

73. We nonetheless bear in mind that we have no evidence that the Banks' breaches of the custody rules led to delays in the return of assets to clients in 2011, or indeed subsequently. The print-out from the GSP demonstrated that it identified each client and the ultimate sub-custodian (i.e., the sub-custodian with actual custody) or central securities depository holding each client's assets. It was not suggested that in general day-to-day operation the system did not work reasonably well.

74. An insolvency would have enormous consequences. According to the experts:

> *2.6 Even with fully CASS-compliant records it would not be possible to agree 100% of client accounts for custody assets for over 6,000 clients in the first twelve months of the insolvency.*
>
> *2.7. No asset returns, other than by exception, should be expected in the first six months of an appointment. It is not possible to give a meaningful estimate of the number of clients to whom assets would be returned in the initial twelve months, as the level of potential problems and disputes can only be guessed at, but it should prove possible to return assets to some proportion of clients in that period, with returns to the remainder requiring a longer timescale and possibly taking many years.*

75. The costs of a Group insolvency would be very substantial. The experts opined:

> *2.9 Costs of the process to return assets to clients in a situation of full CASS-compliance might represent a percentage between 1% and 2% of the value of custody assets (being the approximate charges used in LBIE [Lehman*

Brothers]). With custody assets valued at £1 trillion, that produces a costs estimate between £10 billion and £20 billion.

76. Those costs would in all probability be met out of custody assets.

The Tribunal's assessment of sanctions

(a) Financial sanctions

77. The Respondents accept that financial sanctions are appropriate. The issue is as to the size of the financial sanctions.

78. For this purpose the Tribunal has had regard to the current Accountancy Scheme Sanctions Guidance, including, in particular, the advice as to the purposes of sanctions in paragraphs 8 to 10.

79. Both the Executive Counsel and the Respondents referred to and commented on the list of factors set out under paragraph 21 of the Guidance, and we comment on them in the Appendix to our Decision.

80. On behalf of the Executive Counsel, Mr Cox QC submitted that this was an exceptional case that merited a fine of at least £12.5 million. We agree that this case is exceptional by reason of the value of the assets that should have been the subject of an audit report on compliance with the CASS rules.

81. The case is exceptional in another sense, in that the Misconduct consisted of a failure to understand and to apply fundamental rules of CASS, requiring the Banks to keep their own records and carry out their asset reconciliations on their own legal entity basis. No dishonesty or recklessness was involved, but the Misconduct involved the misapplication of rules that, as the fine imposed on the Banks shows, are of very great importance to the financial system. Mr Hinton and KPMG appreciated that the expression "firm" within the meaning of the CASS rules meant the legal entity carrying out the financial services involved, since Mr Hinton issued a separate CASS audit report for each of the Banks. However, he did not carry that appreciation through to the requirements of the audit.

82. If we focus on the nature of the Misconduct in isolation, without its context and potential consequences, it is evident that there could be far more serious Misconduct, involving dishonesty or recklessness, neither of which is present here. However, the context and potential consequences are highly relevant. They required KPMG and Mr Hinton to take the most assiduous steps to ensure that they correctly interpreted and applied the CASS rules.

83. The Sanctions Guidance is intended to promote, in addition to proportionality, clarity and consistency in decision making. At paragraph 7 it states:

> *Tribunals may have regard to sanction imposed in other cases.*

Not "must". It continues:

> *[Tribunals] must, however, determine the sanction which they think appropriate, on the facts and circumstances of the case before them and should not feel constrained by the sanctions imposed (or not imposed) in earlier cases which they do not think appropriate.*

84. For KPMG and Mr Hinton, Mr Thanki QC placed great weight on the decision of the Tribunal in *JP Morgan*, described in their written submissions as "the leading case". It is indeed the only previous decision of a Tribunal in relation to CASS audits, but we consider it with the above guidance in mind. *JP Morgan* concerned breaches of the CASS rules that, on one view, were more serious than the present Misconduct, and that certainly was prolonged in a way that the present Misconduct was not. PwC had failed over the course of seven consecutive CASS audits to identify that at the end of each day JP Morgan was effecting daily cash "sweeps" of segregated client assets into consolidated overnight interest-bearing accounts. This had the result that at the end of each day client assets ceased temporarily to be segregated. The balances desegregated each day were of amounts up to US$23.21bn. The Tribunal imposed a fine of £1.4 million and a Severe Reprimand.

85. On the basis of the decision in *JP Morgan*, Mr Thanki QC submitted that the fine to be imposed on KPMG in the present case should be no greater than that imposed in that case. Given that the Misconduct was said to be more serious in that case, this submission impliedly recognises that the level of fines imposed by Tribunals has increased since it was decided in 2012. The *Independent Review of the FRC's Enforcement Procedures Sanctions*, to which we have had regard, pointed out without comment that this fine was described by the City Editor of the Financial Times as "*disgracefully small*" and added that a fine of £6 million "*would have been closer to the mark*".

86. We nonetheless accept that, as stated by the Tribunal in *JP Morgan,* the fine imposed on auditors should not, in general, be linked with the fine imposed on the audit subject (here, the Banks). That is particularly so in this case, where the Banks' breaches of the CASS rules were prolonged and went further than those to which the Respondents' Misconduct related, and where the basis of the calculation of the amount of the fine is very different from the principles applied by this Tribunal.

87. Conversely, although the CASS audit fees paid to KPMG for the 2011 CASS audits are relevant, they cannot limit the size of the appropriate fine, having regard to the purposes for which it is imposed.

88. The substance of KPMG's Misconduct lies in its failure to ensure appropriate training, support and supervision for the 2011 CASS audits of the Banks, in a context that could scarcely be more important. The size of the fine must demonstrate to the Respondents, the profession and the public the very great importance of ensuring that these regulatory rules are correctly applied and complied with. It must act as a deterrent against failures to comply with regulatory requirements. The appropriate fine must take into account KPMG's poor disciplinary record in relation to audits, but also the steps it has taken to prevent a recurrence and its part in promoting effective CASS audits since 2012. We also take into account that a fine should not be such as to deter accountants from accepting audit or CASS audit engagements.

89. The Tribunal considers that, subject to any other mitigating or aggravating circumstances, the appropriate fine to be imposed on KPMG is £5 million, to be reduced by the agreed percentage of 30 per cent on account of its acceptance of its Misconduct.

90. There are no aggravating factors. The Tribunal has referred to and taken into account the mitigating factors to which we have referred. Accordingly, after discount of 30 per cent above, the amount of the fine to be imposed is £3.5 million.

91. The Executive Counsel seeks a fine of £200,000 to be imposed on Mr Hinton. On his behalf it is submitted that a fine of £50,000 would be sufficient. We pay particular regard to the effect of the Misconduct and of these proceedings on him. We consider that the appropriate figure is £75,000, reduced on account of his admission to £52,500.

Non-financial sanctions

92. The Misconduct by KPMG is sufficiently serious to justify a Severe Reprimand.

93. The Executive Counsel seeks the following non-financial sanctions against KPMG:

(a) Between the date of this order and 31 May 2022, KPMG shall undertake at least one quality performance review (QPR) in respect of the planning and execution of a CASS audit by each person who signs the Client Asset Report on behalf of KPMG during that period.

(b) By 31 May in each of 2020, 2021 and 2022, KPMG shall provide a written report to the FRC's Executive Counsel setting out details of the QPRs that have been carried out, the conclusions that it has drawn from them, and any actions that have or will be taken ((a) and (b) together comprise the QPR Sanction).

(c) Until 31 May 2022 KPMG shall ensure that a partner is appointed on all CASS engagements that are categorised as "high risk" or

"significantly high risk", as engagement leader, or as engagement quality control reviewer, or as both (the Partner Engagement Leader/EQCR Sanction).

94. For the reasons set out in Freshfields' letter of 20 May 2019 to which we have referred above, the Tribunal accepts that to require the appointment of a partner in all high risk CASS engagements in addition to significantly high risk engagements would be disproportionately onerous. The Tribunal will not therefore impose the Partner Engagement Leader/EQCR Sanction.

95. However, the Tribunal does not consider the QPR Sanction to be unduly onerous, having regard to the qualified recent improvements in KPMG's audits. The Tribunal does accept the point made by Freshfields at paragraph e) of their letter of 20 May 2019 that the QPR Sanction as proposed by the Executive Counsel is not aligned to the firm's QPR cycle and therefore it is not reasonably practical for KPMG to comply with it. The Tribunal therefore amends this proposed sanction, and imposes the following Condition:

(a) Between the date of this order and 30 September 2022, KPMG shall undertake at least one quality performance review (QPR) in respect of the planning and execution of a CASS audit by each person who signs the Client Asset Report on behalf of KPMG during that period.

(b) By a date to be nominated by KPMG in each of 2020, 2021 and 2022, KPMG shall provide a written report to the FRC's Executive Counsel setting out details of the QPRs that have been carried out, the conclusions that it has drawn from them, and any actions that have or will be taken ((a) and (b) together comprise the QPR Sanction).

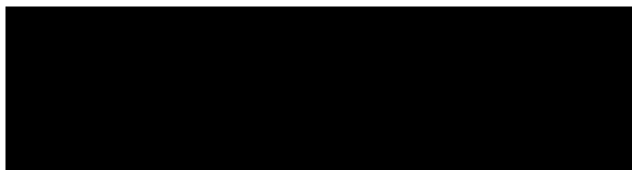
96. Mr Hinton's Misconduct justifies a Reprimand. Given KPMG's admission of its failure to provide for him appropriate training and support, and given that Mr Hinton was not a partner at the time of the Misconduct, the Tribunal considers that a Severe Reprimand is not necessary. For these reasons, and taking into account his present practice, the Tribunal does not consider it necessary to impose a Condition on Mr Hinton.

Costs

97. It has been agreed between the Executive Counsel and KPMG that KPMG will pay to the Executive Counsel the sum of £550,000 in respect of her costs and all of the Tribunal's costs. The Tribunal's costs are in the sum of £31,436.16.

98. In accordance with that agreement, the Tribunal orders KPMG to pay the costs of the Executive Counsel and the costs of the Tribunal in the above sums within 28 days of the date of the Tribunal's report.

99. As agreed between the Parties, no order for costs is made against Mr Hinton.



The Right Hon Sir Stanley Burnton
Chairman of the Tribunal

26 June 2019