

Title

The Carrot or the Stick: Finding a balance in the regulatory conundrum.

Abstract

The financial crisis has attracted comment from a wide variety of academics; Niall Ferguson is one such example, a historian commenting on a legal issue. Ferguson called for the jailing of bankers in his Reith lectures for Radio 4 in 2012; such a measure will find support with many commentators and would fit within a deterrence based approach to regulating the financial system. This paper seeks to compare the deterrence based and compliance based approaches, assessing their application in the UK and the US. The approaches are defined based on research by Aires and Braithwaite, as well as Dalvinder Singh; both approaches are considered in turn and a combination of the two approaches can then be identified within the UK and US. Recent examples of enforcement are used to demonstrate the approaches in practice, identifying both the advantages and disadvantages. On assessment the paper concludes that no one approach should be adopted, both should be implemented in moderation in order to gain the most advantage from each. It will also be argued that the enforcement measures in place are unfulfilling and that a wider range of sanctions should be sought.

Introduction

“A complex financial world will be made less fragile only by simplicity of regulation and strength of enforcement.”¹ These are the words of Niall Ferguson, from one of the Reith Lectures he gave for BBC Radio 4 in 2012. The political nature of banking regulation and its impact on the economy draws out the opinions of many public figures from a wide range of specialties. A journalist and a historian, Ferguson is not a principle source of legal authority, but he does make a persuasive argument, delivered in a concise and reasoned manner.

¹ Niall Ferguson, ‘The Darwinian Economy’ (BBC Reith Lectures, 26 June 2012)
<<http://www.bbc.co.uk/programmes/b01jmxqp/features/transcript>> accessed 01 December 2012

On the face of it, it is hard to disagree with Niall Ferguson's statement; it is illogical to insist on over complexity and a weak enforcement strategy. Ferguson advocates the use of prison sentences and argues this prospect should be a "clear and present danger in the minds of today's bankers"² as a consequence of transgressions. This type of regulation would fall into the 'deterrence' model under the split identified by Reiss.³

In order to assess the effectiveness of regulation, the two broad models and their implications must be discussed. The specific issue of adverse publicity will be explored; this is pertinent to financial regulation because of its effect on confidence. From this discussion the strategy in the UK can be identified and compared to that of the US and international initiatives. Using these comparisons and the relevant theory behind the approaches it will be argued a balance of the two approaches is required to create the optimum regulatory environment.

Models of Regulation

Scholz identifies the two distinctive enforcement strategies, firstly the 'deterrence-based' or "*rule orientated strategy [seeking] compliance through the maximal detection and sanctioning of violations of legal rule.*"⁴ Secondly the 'compliance-based' or "*cooperative strategy [which] emphasizes flexible or selective enforcement that takes into consideration the particular circumstances of an observed violation.*"⁵ In deciding upon a strategy to employ, the mentality of the regulated must be considered. Ayres and Braithwaite consider Justice Holmes adoption of the deterrence model, Holmes argued the law should be tailored

² *Ibid*

³ Albert Reiss, 'The Policing of Organizational Life' (International Seminar on Management and the Control of Police Organizations, Nijenrode, Netherlands, 1980)

⁴ John T. Scholz, 'Cooperation, Deterrence, and the Ecology of Regulatory Enforcement' (1984) 18 *Law and Society Review* 179, at p179

⁵ *Ibid* at p180

towards 'bad men' as they would try to evade it, 'good men' need not be considered as they will still conform.⁶ Singh identifies the deterrence method as the appropriate approach to what Kagan and Scholz describe as the 'amoral calculator'⁷, only interested in profits, these people will weight up the possible benefits against the likelihood of getting caught. In pursuing a deterrence-based approach the regulator will hope to make the probability of detection, and resultant consequence too high a risk to take. Ferguson's proposal would be an example of the deterrence-based approach; he advocates exemplary punishments to instil fear in others. He identifies "greedy people"⁸, who can be likened to the 'amoral calculator' in that they will offend if it is "unlikely to be noticed or severely punished."⁹ Through high profile maximum punishments the regulated are encouraged to exercise "individual prudence"¹⁰

Drawbacks to the deterrence-based approach have been identified; Lansky observes that if punishment rather than dialogue is pursued, the regulated will resent and resist the regulator, arguing this as "basic to human psychology."¹¹ Ayres and Braithwaite argue this creates a regulatory game of cat-and-mouse.¹² Additionally, pursuing punishments is expensive; resources must be used on investigation and litigation. This can remove resources from monitoring the regulated, "[a] *highly punitive mining inspectorate will spend more time in court than in mines.*"¹³

⁶ Justice Holmes, in the Corporate Crime Reporter, 18 April 1988. Cited by Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford Social-Legal Studies, OUP, 1992) at p.20

⁷ R.A Kagan and J. T. Scholz, 'The Criminology of the Corporation and Regulatory Enforcement Strategies' in Hawkins and Thomas (ed), *Enforcing Regulation (Law in a Social Context)* (Kluwer Nijhoff 1984) in Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate 2007) p.117

⁸ Niall Ferguson, 'The Darwinian Economy' (BBC Reith Lectures, 26 June 2012)
<<http://www.bbc.co.uk/programmes/b01jmxqp/features/transcript>> accessed 01 December 2012

⁹ *Ibid*

¹⁰ *Ibid*

¹¹ Melvin R. Lansky, 'Violence, Shame and the Family' (1984) 5 *International Journal of Family Psychiatry* 21

¹² Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford Social-Legal Studies, OUP, 1992) at p.20

¹³ *Ibid*

The compliance-based approach centres on open dialogue between the regulator and the regulated; Singh describes it as a “*two-way process*”,¹⁴ the polar opposite to the deterrence approach.¹⁵ The regulator sets rules and gives reasons for observing them, the regulated will feedback on these rules with a view to tailor them to suit their needs.¹⁶ This approach is concerned with the on-going relationship between the regulator and the regulated. This system provides means for the regulated to have some input in the way they are regulated and ideally creates a cooperative relationship between the two parties. Using the compliance-based approach can also involve consultation with the regulated; this can provide the regulator with valuable insight into the concerns of the regulated. The compliance-based approach begins with the opposite assumption to deterrence-based approach; it considers the regulated ‘good men’ under Holmes analogy,¹⁷ the ‘political citizen’ as identified by Kagan and Scholz.¹⁸ These people will comply with reasonable regulations for numerous reasons, such as the public good and best practice.¹⁹ Actions for misdemeanours under the compliance-based approach will depend on individual circumstances, the regulator will take the offender previous relations into account and may exercise discretion in the resultant penalty if there is to be one, and reduced sanctions can be offered as incentives to ‘come clean’ about infringements.²⁰

¹⁴ Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate 2007) at p.115

¹⁵ *Ibid* at p.114

¹⁶ *Ibid* at p.115

¹⁷ Justice Holmes, in the Corporate Crime Reporter, 18 April 1988. Cited by Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford Social-Legal Studies, OUP, 1992) p.20

¹⁸ R.A Kagan and J. T. Scholz, ‘The Criminology of the Corporation and Regulatory Enforcement Strategies’ in Hawkins and Thomas (ed), *Enforcing Regulation (Law in a Social Context)* (Kluwer Nijhoff 1984) in Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate 2007)

¹⁹ Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate 2007) p.117

²⁰ *Ibid* at p.116

Criticisms of the compliance-based approach can be found in the reasoning for adopting the deterrence-based approach; one example is ‘amoral calculators’ can exploit it.²¹ If a regulator is known to take a compliance-based approach, an ‘amoral calculator’ will be more likely to violate rules based on the assumption they will either not be caught, or if they are caught, they will not receive a strong punishment. The regulated will also complain about the approach, employing and educating staff to interpret compliance rules creates financial burdens upon them. A deterrence-based approach will cost the regulated less, though they will incur legal fees if they were pursued in the courts.

Ayres and Braithwaite,²² Kagan and Scholz,²³ and Singh all agree that a combination of the deterrence and compliance approaches should be exercised; Singh recommends a balance to be struck.²⁴ Ayres and Braithwaite put forward the ‘tit-for-tat’ model of regulation,²⁵ this promotes the use of compliance, or persuasive techniques first and then a steady escalation of punitive measures to address non-compliance. They argue that “*punishment is expensive*” and that persuasion should be adopted first, this will then leave further resources available to address noncompliance. Starting from a compliance-based position is conducive to healthy relationship between the regulator and the regulated, discouraging the cat-and-mouse situation and the constant search for gaps in regulation; this can lead to complex regulation in order to close gaps which inevitably form when attempting to write rule based regulation.²⁶

²¹ Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford Social-Legal Studies, OUP, 1992) p.19

²² *Ibid* at p.20

²³ R.A Kagan and J. T. Scholz, ‘The Criminology of the Corporation and Regulatory Enforcement Strategies’ in Hawkins and Thomas (ed), *Enforcing Regulation (Law in a Social Context)* (Kluwer Nijhoff 1984) in Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate 2007)

²⁴ Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate 2007) p.116-118

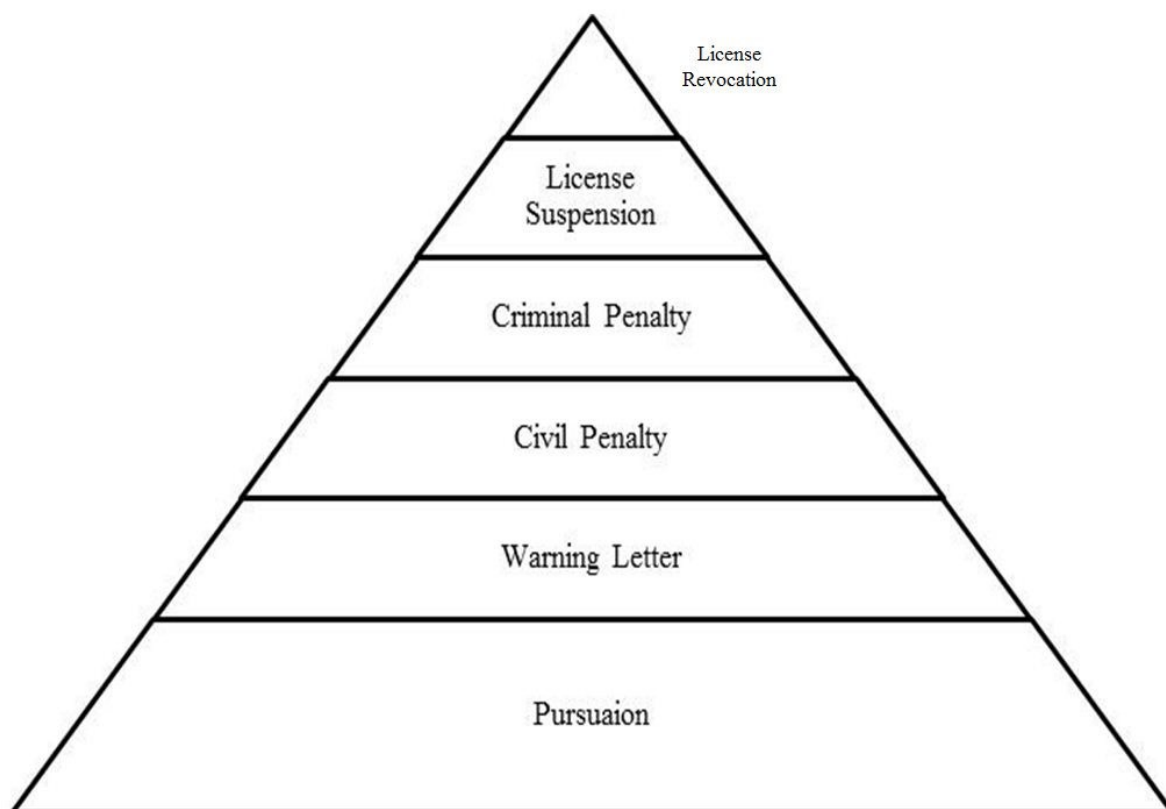
²⁵ Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford Social-Legal Studies, OUP, 1992) p.26

²⁶ *Ibid*

Over complex legislation is what Ferguson perceives to be wrong with the current system,²⁷ but the deterrence-based solution he advocates could be a contributor to these complex rules. The third reason Ayres and Braithwaite give for a ‘tit-for-tat’ approach is particularly pertinent to the fast evolving sector the regulators are charged with, a persuasive start point is important “*in industries where technological and environmental realities change to quickly that the regulations... cannot keep up to date.*”²⁸

The ‘tit-for-tat’ approach, proposed by Ayres and Braithwaite, puts a focus on steady escalation in response to noncompliance; this is visually represented in Figure.1.

Figure 1²⁹



²⁷ Niall Ferguson, ‘The Darwinian Economy’ (BBC Reith Lectures, 26 June 2012)

<<http://www.bbc.co.uk/programmes/b01jmxqp/features/transcript>> accessed 01 December 2012

²⁸ Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford Social-Legal Studies, OUP, 1992) p.26

²⁹ *Ibid* at p.35

The pyramid in Figure.1 demonstrates a hierarchy of sanctions, and the decreasing size of the sections moving up the pyramid corresponds to the decreasing requirement to use those sanctions.³⁰ Considering academic argument, Ferguson's proposals can still be incorporated into a 'tit-for-tat' approach, after previous mechanisms have been exhausted. In pursuing the 'tit-for-tat' predictability is also instilled, a cornerstone of the law. The regulated know what will happen if they do not comply, this is one way of putting fines and even prison sentences in their minds, as Ferguson wants, and it is simple, which also meets Ferguson's statement.

Adverse Publicity as a Sanction

Adverse publicity is useful tool to pursuing the deterrence-approach,³¹ a regulator is unlikely to deter others if the punishments are not publicised. Furthermore the very publication of wrong doing can be a punishment; it can affect the public image of a firm and lower the market's confidence in that company. Many banks are publically traded companies and adverse publicity can seriously affect their share price, on the announcement of Barclays LIBOR settlements the London Stock Exchange recorded a 15.81% drop in the company's share price.³² Harvey identifies a moral dilemma for the regulator when publicising formal action,³³ the Financial Services Authority (FSA) has statutory objectives of 'maintaining confidence'³⁴ and 'reducing financial crime'.³⁵ Publicity of enforcement is required to reduce

³⁰ *Ibid*

³¹ For analysis see Peter Cartwright, 'Publicity, Punishment and Protection: The Role(s) of Adverse Publicity in Consumer Policy' (2012) Vol. 32 No. 2 Legal Studies 179

³² London Stock Exchange, 'BARCLAYS PLC ORD –News Analysis- London Stock Exchange' <25Phttp://www.londonstockexchange.com/exchange/prices-and-markets/stocks/exchange-insight/news-analysis.html?fourWayKey=GB0031348658GBGBXSET0&page=7> accessed 05 December 2012

³³ Jackie Harvey, 'The Policing of Financial Markets: Where is the Line in the Sand between Criminal Activity and Regulatory Misdemeanour? (Fighting Financial Crime in the Global Economic Crisis: Policy, Trends and Sanctions Conference , Bristol, November 2006)

³⁴ Financial Services and Markets Act 2000, s.3

³⁵ Financial Services and Markets Act 2000, s.6

financial crime, too great a level of publicity and the confidence of the markets can be undermined;³⁶ therefore a balance must be struck.

Cartwright argues adverse publicity can be as strong as fines;³⁷ he evidences this with Office of Fair Trading (OFT) reports. The OFT found adverse publicity to increase the effectiveness of enforcement actions, the impact of enforcement “*may be minimal where there is limited awareness of the consequences.*”³⁸ In a later report the OFT found 89% of companies considered “*the threat of adverse publicity... as important as any financial penalty*” if the company had breached consumer law.³⁹ The threat being as negative is important, if adverse publicity is something companies are genuinely fearful of then it should be used by regulators, “*the bigger and more various are the sticks, the greater the success regulators will achieve by speaking softly.*”⁴⁰ If companies value their reputations, increasing it should be used as an incentive; companies that consistently comply should receive positive publicity. A counter argument to this would be that compliance is not positive behaviour it is simply what they should do, but such an approach could address the perceived negative relationship between the regulator and the regulated.

The FSA Enforcement Strategy

³⁶ Jackie Harvey, ‘The Policing of Financial Markets: Where is the Line in the Sand between Criminal Activity and Regulatory Misdemeanour? (Fighting Financial Crime in the Global Economic Crisis: Policy, Trends and Sanctions Conference, Bristol, November 2006)

³⁷ Peter Cartwright, ‘Publicity, Punishment and Protection: The Role(s) of Adverse Publicity in Consumer Policy’ (2012) Vol. 32 No. 2 Legal Studies 179

³⁸ The Office for Fair Trading, ‘Drivers of Compliance and Non-Compliance with Consumer Law’ <http://www.offt.gov.uk/shared_offt/reports/Evaluating-OFTs-work/OFT1225a.pdf> accessed 06 December 2012

³⁹ The Office for Fair Trading, ‘Factors Affecting Compliance with Consumer Law and the Deterrent Effect of Consumer Enforcement’ <http://www.offt.gov.uk/shared_offt/reports/Evaluating-OFTs-work/OFT1228.pdf> accessed 06 December 2012

⁴⁰ Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford Social-Legal Studies, OUP, 1992) p.19

The FSA is currently the regulator of the UK financial system;⁴¹ it most recently outlined its approach to enforcement in November 2012 in the latest version of the Enforcement Guide, found in the FSA Handbook.⁴² This outlines the four principles under which the FSA uses its enforcement powers, these are; “*maintaining an open and co-operative relationship with regulators*”,⁴³ proportionality,⁴⁴ fair treatment,⁴⁵ and deter future non-compliance.⁴⁶ Importantly the FSA stipulates it has discretion in handing down an enforcement action, the cooperative relationship will sometimes “*lead the FSA to decide against taking formal disciplinary action.*”⁴⁷ The position the FSA sets out has been seen to be different in practice; regulated firms consider the regulator to have taken a deterrence stance, using sanctions rather than education.⁴⁸ Examples of this can be found in the most recent annual assessment, undertaken by Travers Smith Regulatory Investigations Group.⁴⁹ One example is Mr Osborne. He was fined £350000 for engaging in market abuse, despite the FSA acknowledging Mr Osborne “*was not deliberate or reckless*”⁵⁰ in his actions, he did not “*intend or expect*”⁵¹ dealings based on the disclosed information, and that Mr Osborne did not stand to gain from the resultant sale.⁵² The fine was imposed to “*send a message of*

⁴¹ The UK is currently in a period of transition in financial services regulation. The FSA will cease to exist; in its place the Bank of England will be given responsibility for regulation. Several bodies will be created within the Bank of England. The Financial Policy Committee, which will oversee system wide stability. The Prudential Regulation Authority will be responsible for assessing risk within independent institutions. Finally, the Financial Conduct Authority will be the main regulator; this authority will have enforcement powers, comparable to the FSA at present. The new bodies are given their powers by the Financial Services Act 2012.

⁴² The Financial Services Authority, ‘The Enforcement Guide’

<http://media.fsahandbook.info/Handbook/EG_20121101.pdf> accessed 03 December 2012 at EG

⁴³ *Ibid* at EG 2.2(1)

⁴⁴ *Ibid* at EG 2.2(2)

⁴⁵ *Ibid* at EG 2.2(3)

⁴⁶ *Ibid* at EG 2.2(4)

⁴⁷ *Ibid* at EG 2.4

⁴⁸ Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate 2007) p.126

⁴⁹ Travers Smith Regulatory Investigations Group, ‘FSA Enforcement Action: Themes and Trends’ (2012) 96 (May) C.O.B 1

⁵⁰ FSA, ‘Final Notice: Andrew Jon Osborne 15 February 2012’

<http://www.fsa.gov.uk/static/pubs/final/andrew_osborne.pdf> accessed 10 December 2012 at 2.8

⁵¹ *Ibid*

⁵² *Ibid*

deterrence”,⁵³ this would be reasonable should Mr Osborne have not been such an unfortunate individual. The FSA should have chosen a more deserving individual for this fine, and sought to educate Mr Osborne so as to ensure his future compliance. It is true that this action will serve as warning, but it will also portray the regulator in a bad light, as a bit of a bully, this could act to further push the regulated away and towards the ‘cat-and-mouse’ situation.

The FSA have also criticised for increasing compliance costs, it was claimed last year that it could cost the industry up to £1.4 billion annually to comply with FSA regulations.⁵⁴ This highlights a contributing factor to the compliance approach costing governments and regulators less than the deterrence approach; the costs are borne by the regulated. High compliance costs look set to continue as reports suggest a 20% rise in regulatory costs in the future.⁵⁵

It is difficult to compare the FSA’s use of persuasive approaches to the use of formal sanctions. Persuasive action is not readily available in the public domain; this is deliberate because publicity can be seen as a sanction in itself,⁵⁶ as discussed above. It can be seen from Figure 2 that the FSA did not exercise its sanctioning powers as it often in its first 4 years of existence. The increase in use appears to coincide with the beginning of the credit crisis and has decreased in the last two years.

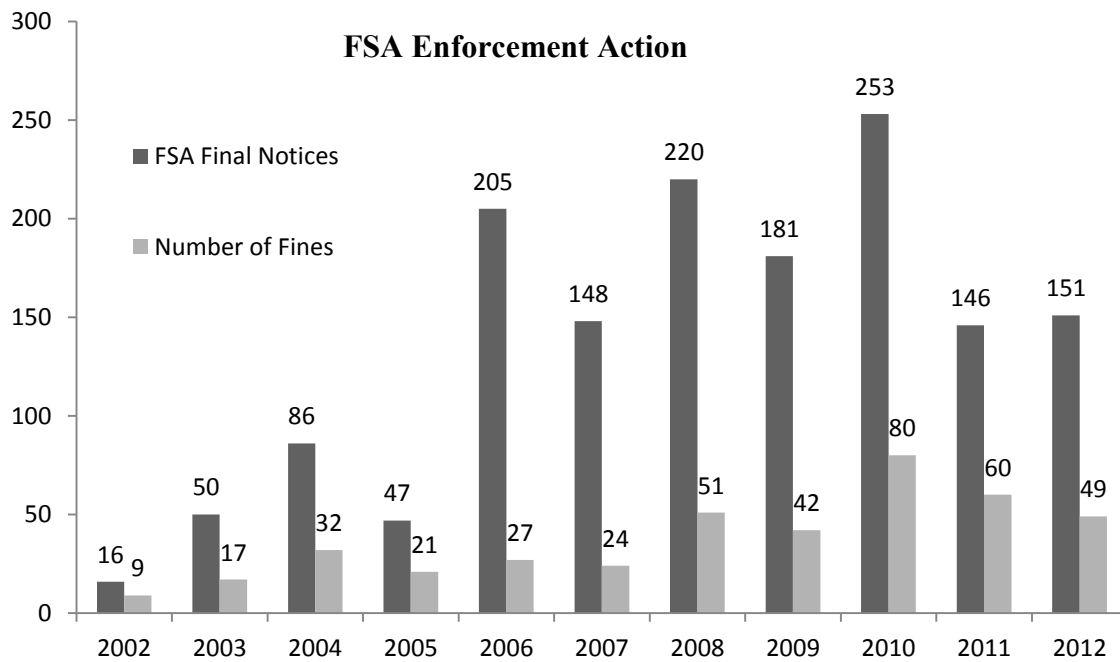
⁵³ Travers Smith Regulatory Investigations Group, ‘FSA Enforcement Action: Themes and Trends’ (2012) 96 (May) C.O.B 1 at p8

⁵⁴ The Telegraph, *Avalanche of New FSA Rules to Cost business £1.4bn a year*
<<http://www.telegraph.co.uk/finance/yourbusiness/8901695/Avalanche-of-new-FSA-rules-to-cost-business-1.4bn-a-year.html>> accessed 09 December 2012

⁵⁵ Money Marketing, *‘PRA and FCA to Push Up Regulatory Costs by 20%*
<<http://www.moneymarketing.co.uk/regulation/pr-and-fca-to-push-up-regulatory-costs-by-20/1056944.article>>
accessed 12 December 2012

⁵⁶ Peter Cartwright, *‘Publicity, Punishment and Protection: The Role(s) of Adverse Publicity in Consumer Policy’* (2012) Vol. 32 No. 2 *Legal Studies* 179

Figure 2⁵⁷

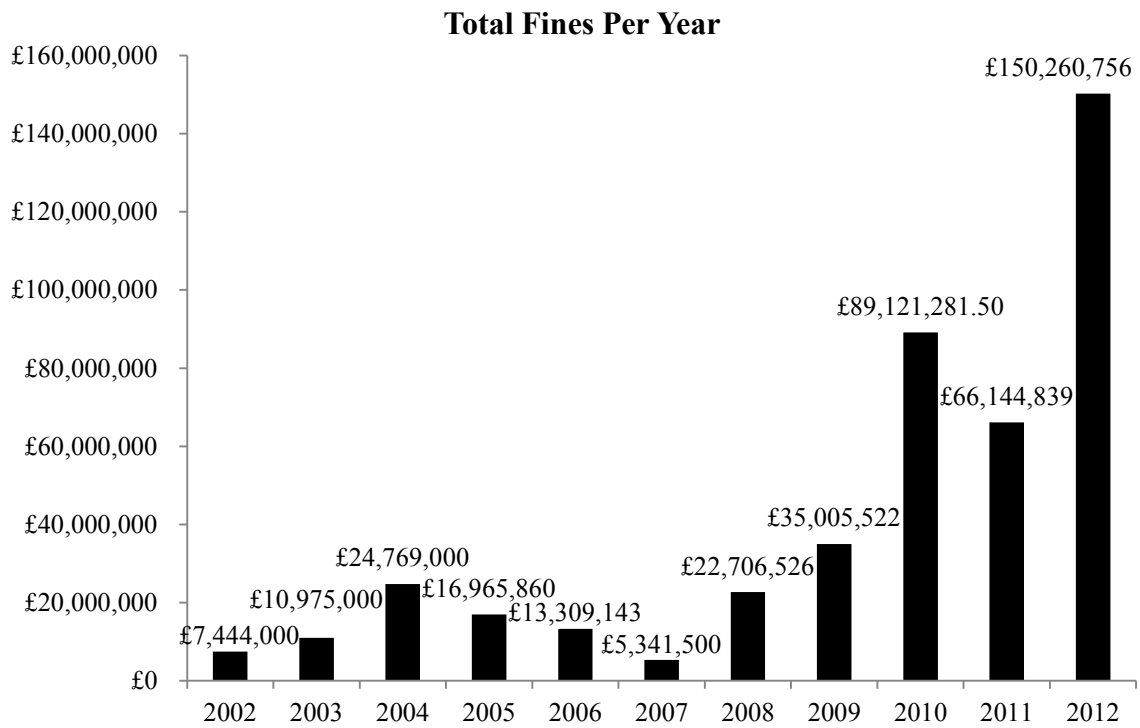


Fines

Figure 3 shows a trend in increasing in total fines, fines in 2012 easily total more than 2002-09 combined. The total number of fines will clearly influence the eventual total value, but there is clear increase in the size of each fine, in 2008 there were more fines than in 2012, yet the total value of fines for 2012 is more than 4 times that of 2008. This trend can be seen in the size of the average fine shown in Figure 4.

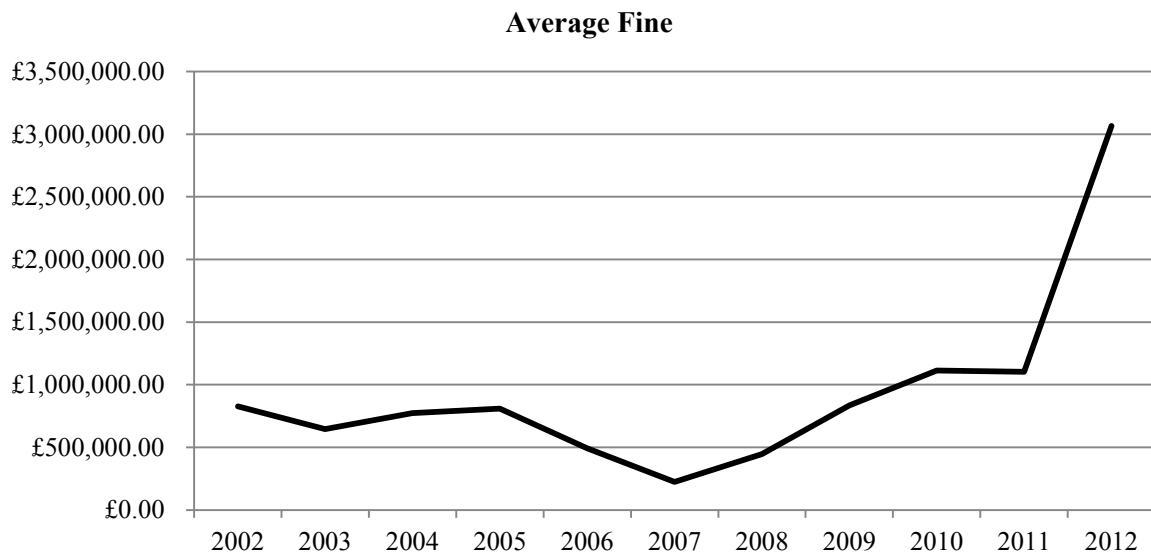
⁵⁷ Based Table 4 compiled based on information extracted from: FSA, 'Enforcement Notices and Application Refusals' <<http://www.fsa.gov.uk/library/communication/notices>> accessed 10 December 2012 and FSA, 'Fines Table' <<http://www.fsa.gov.uk/about/media/facts/fines>> accessed 10 December 2012

Figure 3⁵⁸



⁵⁸ FSA, 'Fines Table' <<http://www.fsa.gov.uk/about/media/facts/fines>> accessed 10 December 2012

Figure 4⁵⁹



The £59.5 million fine of Barclays⁶⁰ will have been a factor in the high average fine for 2012; however there was also a £29.7 million fine for UBS in relation to failings in the Kweku Adoboli case.⁶¹ Despite the size of these fines, questions can still be raised as to the effectiveness of them. Barclays posted pre-tax profits of £5,879 million (nearly £5.9 billion) for 2011,⁶² based on this the FSA fine equates to just 1.012% of Barclays pre-tax profits. The same can be shown for UBS; their fine was worth 0.8% of their pre-tax operating profits of 5,350 million Swiss Francs.⁶³ If fines are going to be used as deterrence mechanisms then

⁵⁹ FSA, 'Fines Table' <<http://www.fsa.gov.uk/about/media/facts/fines>> accessed 10 December 2012

⁶⁰ FSA, 'Final Notice: Barclays Bank PLC' <<http://www.fsa.gov.uk/static/pubs/final/barclays-jun12.pdf>> accessed 10 December 2012

⁶¹ FSA, 'Final Notice: UBS AG' <<http://www.fsa.gov.uk/static/pubs/final/ubs-ag.pdf>> accessed 12 December 2012

⁶² Barclays, 'Barclays PLC: Annual Report 2011'

<[http://group.barclays.com/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobheadername1=Content-Disposition&blobheadername2=MDT-Type&blobheadervalue1=inline%3B+filename%3D2011-Barclays-PLC-Annual-Report-\(PDF\).pdf&blobheadervalue2=abinary%3B+charset%3DUTF-8&blobkey=id&blobtable=MungoBlobs&blobwhere=1330686323829&ssbinary=true](http://group.barclays.com/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobheadername1=Content-Disposition&blobheadername2=MDT-Type&blobheadervalue1=inline%3B+filename%3D2011-Barclays-PLC-Annual-Report-(PDF).pdf&blobheadervalue2=abinary%3B+charset%3DUTF-8&blobkey=id&blobtable=MungoBlobs&blobwhere=1330686323829&ssbinary=true)> accessed 12 December 2012

⁶³ UBS, 'UBS: Annual Report 2011' <http://www.static-ubs.com/global/en/about_ubs/investor_relations/annualreporting/2011/_jcr_content/par/teaserbox_6c86/teaser_a_cb3/linklist/link_9f50.228736590.file/bGluay9wYXR0PS9jb250ZW50L2RhbS9zdGF0aWMvZ2xvYmFsL2ludmVzdG9yX3JlbGF0aW9ucy9hbm51YWwyMDExL0FSMjAxMV9lLnBkZg==/AR2011_e.pdf> accessed 12 December 2012

they surely need to be higher, or they will be seen as affordable, as such the ‘amoral calculator’ will not consider a fine enough of a consequence.

Fines are not the only sanction the FSA uses; Figure 2 shows that fines have accounted for less than half the Final Notices since 2003. The FSA has the power to prosecute and has frequently secured prison sentences for criminal convictions.

Prison Sentences

The fraudulent rouge trader Kweku Adoboli is the most memorable financial crime case to come to court in the UK in 2012, sentenced to 7 years in prison after causing £1.4bn in losses.⁶⁴ Prior to this, in May the Travers Smith Regulatory Investigations Group had described 2012 as a “*quieter few months*”⁶⁵ in relation to criminal cases, however they did point out that 20 individuals were facing trial at the time.⁶⁶ Some of these can be seen to have yielded convictions; a four and a half year sentence for money laundering in April,⁶⁷ three convictions for insider dealing received a total of nine years and ten months in June,⁶⁸ and six more insider dealing convictions adding up to sixteen years in July.⁶⁹ The Adoboli sentence was the maximum he could have expected based on sentencing guidelines.⁷⁰

⁶⁴ BBC News, ‘Rouge trader Kweku Adoboli Sentenced for £1.4bn Loss’

<<http://www.bbc.co.uk/news/business-20416866>> accessed 10 December 2012

⁶⁵ Travers Smith Regulatory Investigations Group, ‘FSA Enforcement Action: Themes and Trends’ (2012) 96 (May) C.O.B 1 at p.4

⁶⁶ *Ibid*

⁶⁷ FSA, ‘FSA Secures Four and a Half Year Jail Sentence for Man Convicted of Laundering Boiler Room Funds’ <<http://www.fsa.gov.uk/library/communication/pr/2012/045.shtml>> accessed 10 December 2012

⁶⁸ FSA, ‘Three Sentenced for Insider Dealing’

<<http://www.fsa.gov.uk/library/communication/pr/2012/067.shtml>> accessed 10 December 2012

⁶⁹ FSA, ‘Six Sentenced for Insider Dealing’ <<http://www.fsa.gov.uk/library/communication/pr/2012/080.shtml>> accessed 10 December 2012

⁷⁰ CPS, ‘Fraud, False Accounting, Fraudulent Evasion of VAT, False Statement for Vat Purposes, Conduct Amounting to an Offence’ <http://www.cps.gov.uk/legal/s_to_u/sentencing_manual/fraud> accessed 20 December 2012

United States Enforcement

The US provides a good comparison to the UK, having a similar legal system facing the similar issues. It employs a comparable approach in that it will sentence individuals to prison sentences and fines individuals and firms. The US has been seen to use longer sentences and higher fines than the UK, with a variety of offences warranting a prison term.

Prison Sentences

The US has much higher maximum sentences for financial crime than the UK and has had a fraud offence since 1872;⁷¹ China is even stricter, it uses the death penalty for some white-collar crimes.⁷² The US has a maximum prison sentence of 20 years for fraud and money laundering;⁷³ it criminalises a wide range of fraudulent activities, and often sets sentences to run consecutively.⁷⁴ Offences attracting prison sentences include; mail fraud,⁷⁵ bank fraud⁷⁶ and securities and commodities fraud.⁷⁷

The record prison sentence for fraud was given to Shalom Weiss in 2000 who received a total of 845 years in 2000; his accomplice was sentenced to 740 years.⁷⁸ In an even more high profile conviction Bernard Madoff was sentenced to 150 year imprisonment in 2009.⁷⁹ These are extreme examples but cases are frequent, a sentence from as recent as 11 December 2012,

⁷¹ Mail Fraud Statute 1872 now found in the Criminal Code: 18 U.S.C §1341

⁷² Reuters, 'China Sentences Woman to Death for \$16 million Fund Scam' <<http://www.reuters.com/article/2012/04/06/us-china-economy-death-idUSBRE83508920120406>> accessed 11 December 2012

⁷³ Nicholas Ryder, *Financial Crime in the 21st Century: Law and Policy* (Edwin Elgar 2011) at p266

⁷⁴ The Guardian, 'Why do US Judges Give Such Long Prison Sentences?' <<http://www.guardian.co.uk/law/shortcuts/2012/mar/07/us-judges-long-prison-sentences>> accessed 13 December 2012

⁷⁵ 18 U.S.C §1341

⁷⁶ 18 U.S.C §1344

⁷⁷ 18 U.S.C §1348

⁷⁸ Nicholas Ryder, *Financial Crime in the 21st Century: Law and Policy* (Edwin Elgar 2011) at p280

⁷⁹ BBC News, 'Fraudster Madoff gets 150 years' <<http://news.bbc.co.uk/1/hi/business/8124838.stm>> accessed 11 December 2012

a 6 and a half year sentence for a \$1.3 million phishing scheme;⁸⁰ only half a year less than Adoboli for the loss of less than 10% that of Adoboli. Cases such as this show the willingness of the US to criminalise and imprison financial criminals for long periods of time, much longer than in the UK.

Fines

A similar conclusion can be drawn from comparing US and UK fines; the US imposes far higher penalties than the UK. The LIBOR scandal provides a direct comparison in fines to Barclays. The FSA fined Barclays £59.5 million, the highest fine ever given. This is made to look small by the \$200 million and \$160 million fines imposed by the Commodity Futures Trading Commission⁸¹ and Department of Justice⁸² respectively. Despite the US fines were still only to the value of 3.933% of Barclays 2011 profits.⁸³ These fines are not the biggest this year; HSBC recently received a \$1.9 billion fine for failing in its money laundering controls.⁸⁴ This fine is a lot more significant than any UK fine, 8.687% of HSBC's 2011 profits,⁸⁵ but still unlikely to really impact a Bank which made \$21.872 billion last year.⁸⁶

International Intervention

Presently there are no international organisations with the power to undertake enforcement actions against banks; this could soon be to change if the states using the Euro currency agree

⁸⁰ FBI, 'Georgia Man Sentenced to 75 Months in Prison for Role in \$1.3 Million Phishing Fraud Scheme' <<http://www.fbi.gov/newark/press-releases/2012/georgia-man-sentenced-to-75-months-in-prison-for-role-in-1.3-million-phishing-fraud-scheme>> accessed 12 December 2012

⁸¹ Commodity Futures Trading Commission, 'CTFC Orders Barclays to pay \$200 Million Penalty for Attempted Manipulation of and False Reporting concerning LIBOR and Euribor Benchmark Interest Rates' <<http://www.cftc.gov/PressRoom/PressReleases/pr6289-12>> accessed 11 December 2012

⁸² Department of Justice, 'Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Rate and Agrees to Pay \$160 Million Penalty' <<http://www.justice.gov/opa/pr/2012/June/12-crm-815.html>> accessed 11 December 2012

⁸³ Based on 27th June 2012 exchange rate of 1 USD = 0.6422 GBP

⁸⁴ BBC News, 'HSCA To Pay £1.9bn In US Money Laundering Penalties' <<http://www.bbc.co.uk/news/business-20673466>> accessed 12 December 2012

⁸⁵ HSBC, 'HSBC Holdings PLC: Annual Report and Accounts 2011' <http://www.hsbc.com/1/content/assets/investor_relations/hsbc2011ara0.pdf> accessed 13 December 2012

⁸⁶ *Ibid*

to instil powers in the European Central Bank.⁸⁷ There are some international organisations which produce recommendations for states to comply with, including the Bank for International Settlements (BIS) and the Financial Action Task Force (FATF). Without any sanctioning powers the guidance these bodies can provide is only compliance-based. The power of these recommendations depends on their implementation by sovereign states; the UK is a member of the Basel Committee on Banking Supervision as well as a FATF.

FATF provides recommendations in combating “*money laundering, terrorist financing and other related threats to [...] the international financial system.*”⁸⁸ It produces periodic reports assessing the compliance of member states; it has found the UK to be largely compliant. The UK was encouraged to become fully compliant but there are no consequences for not doing so. A discussion classifying the UK as a ‘political citizen’ or ‘amoral calculator’ would probably require a book of its own, but assuming the UK to be a ‘political citizen’ its variety of motivations may still lead to it not complying with the remaining recommendations. The UK might feel it already goes far enough, or consider the recommendations to go too far.

The Basel Committee recommends international standards for banking regulation⁸⁹ and encourages common approaches to supervision. The current accords are divided into 3 pillars; the first concerns minimum capital requirements,⁹⁰ the second provides framework for

⁸⁷ Reuters, ‘With Germany On Side, EU Nears Banking Union Deal’ <<http://www.reuters.com/article/2012/12/12/us-eu-banking-idUSBRE8BB00820121212>> accessed 12 December 2012

⁸⁸ FATF, ‘Who we are’ <<http://www.fatf-gafi.org/pages/aboutus/>> accessed 12 December 2012

⁸⁹ Bank For International Settlements ‘History of the Basel Committee and its Membership’ <<http://www.bis.org/bcbs/history.htm>> accessed 12 December 2012

⁹⁰ Bank For International Settlements ‘Basel Committee on Banking Supervision: International Convergence of Capital Measurement and Capital Standards, A Revised Framework’ <<http://www.bis.org/publ/bcbs128.pdf>> accessed 12 December 2012

supervisory review, and finally,⁹¹ the third pillar contains recommendations on market discipline.⁹² The current set of Accords are known as Basel III, and like the FATF recommendation, are not enforceable automatically as the Basel Committee has not “*formal supranational supervisory authority*.”⁹³ The Accords are given legal force by the European Union⁹⁴ which makes them binding upon the UK as a member state. The Basel Accords are a minimum standard for best practices; they do not contain any enforcement measures, the enforcement of requirements remains with the individual states and regulators.

Conclusion

The use of prison sentences and fines is the main way regulators enforce financial regulations, this can be seen from the use of the FSA’s powers. The same can be seen in the US but with much higher fines and longer sentences. These measures are clearly part of the deterrence approach to regulating. The effectiveness of the deterrence approach has been questioned; it is seen to be expensive⁹⁵ and encourages a negative relationship between the regulator and the regulated.⁹⁶ The compliance approach is also pursued in the UK, it is a contrast to the deterrence approach, it seeks to control through communication and incentives. This has also been criticised, it has been seen as open to abuse⁹⁷ and imposing costs on the regulated.⁹⁸ The combination of the two appears to be the best compromise: ‘tit-

⁹¹ Bank For International Settlements ‘Basel Committee on Banking Supervision: International Convergence of Capital Measurement and Capital Standards, A Revised Framework’ <<http://www.bis.org/publ/bcbs128.pdf>> accessed 12 December 2012

⁹² *Ibid*

⁹³ Bank For International Settlements ‘History of the Basel Committee and its Membership’ <<http://www.bis.org/bcbs/history.htm>> accessed 12 December 2012

⁹⁴ Directive (EU) 76/2010 of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards to capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies [2010] OJ L329/3

⁹⁵ Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford Social-Legal Studies, OUP, 1992)

⁹⁶ *Ibid*

⁹⁷ *Ibid*

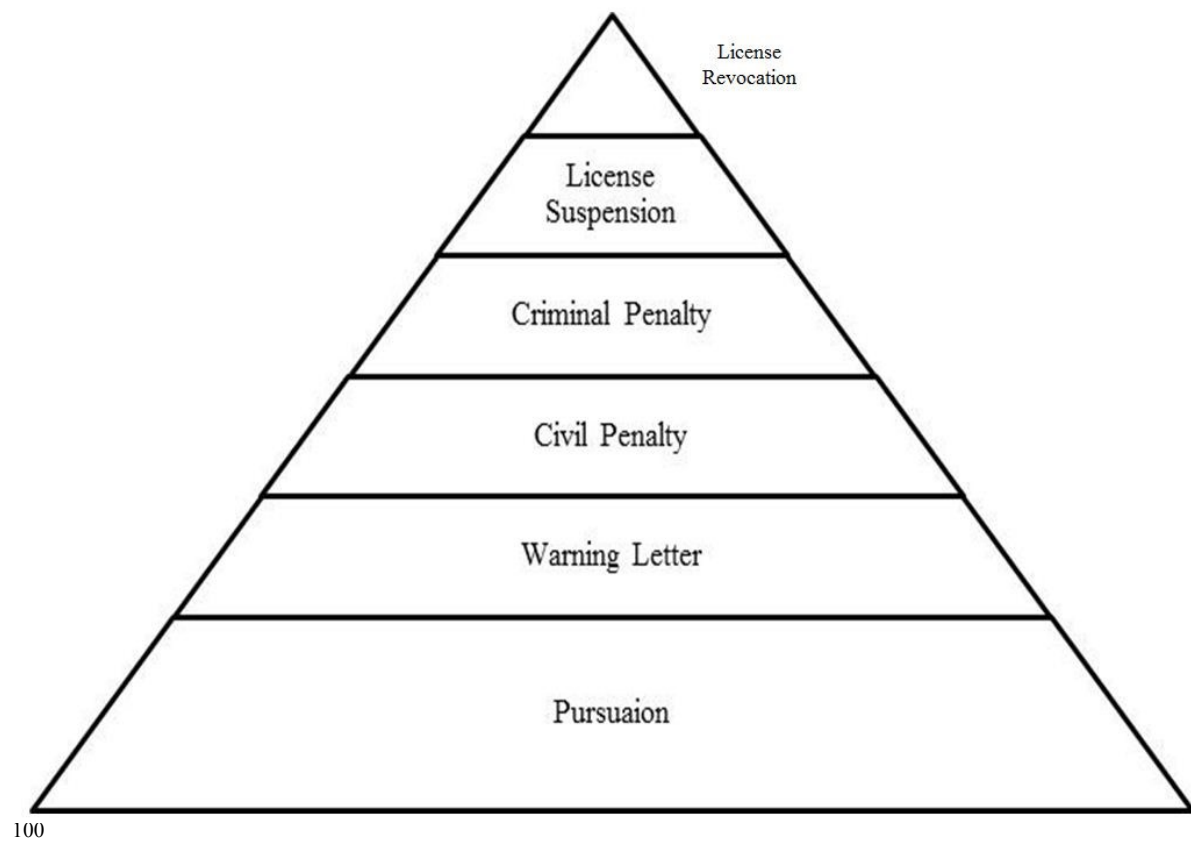
⁹⁸ Money Marketing, ‘PRA and FCA to Push Up Regulatory Costs by 20%’ <<http://www.moneymarketing.co.uk/regulation/pr-and-fca-to-push-up-regulatory-costs-by-20/1056944.article>> accessed 12 December 2012

for-tat'. In the case of Mr Osborne, lower level punishment would have been better suited, but in the case of big banks abusing regulations higher fines are needed. Perhaps the better approach from the regulators is to see to come up with an alternative. Fines are unlikely to influence banks, and it would be disproportionate to impose fines based on the banks' profits. It could be more effective to impose restrictions on offending companies, ban them from specific markets if they offend, not allow them to return until all staff members pass a compliance course, and offset the costs of this by making the company pay the fees. If the consequences are genuinely more inconvenient than the benefits of not complying then the 'amoral' calculator will comply. Complexity is clearly not an aim of financial regulation, yet simplicity is perhaps unattainable due to the vast system which requires regulation. Certainty should be a goal of financial regulation, whatever the agreed enforcement action for a specific offence it should be clearly warned of, and proportionately applied, ideally that enforcement should relate to the offence committed. The present approach looks set to continue with the FSA becoming the FCA when the Financial Services Bill is eventually enacted, it is expected the FCA will pursue a policy of deterrence, imposing "*higher penalties against high-profile targets*".⁹⁹ This arguably removes certainty; it is hard to predict how high an exemplary fine will be. Enforcement should be strong or it is ineffective, but it must be proportionate.

⁹⁹ Travers Smith Regulatory Investigations Group, 'FSA Enforcement Action: Themes and Trends' (2012) 96 (May) C.O.B 1 at p.2

Appendices

Figure 1



¹⁰⁰ Replicated based on Ayres and Braithwaite, *Responsive Regulation: Transcending the deregulation Debate* (Oxford Social=Legal Studies, OUP, 1992) p35

Table 1 Barclays¹⁰¹

		% of Barclays 2011 Pre-Tax Profits
Barclays 2011 Pre-Tax Profits	£5,879,000,000.00	100
FSA Fine	£59,500,000.00	1.012076884
US Fines		
Commodity Futures Trading Commission	\$200,000,000.00	
In GBP ¹⁰²	£128,440,000.00	2.184725293
Department of Justice	\$160,000,000.00	
In GBP ⁱ	£102,752,000.00	1.747780235
Total US Fines	\$360,000,000.00	
In GBP	£231,192,000.00	3.932505528
Total Fines (GBP)	£290,692,000.00	4.944582412
1% of Barclays Pre-Tax Profits	£58,790,000.00	1

Table 2 UBS¹⁰³

		% of UBS 2011 Pre-Tax Profits
UBS 2011 Pre-Tax Profits (CHF)	CHF 5,350,000,000.00	
In GBP ¹⁰⁴	£3,689,895,000.0000	100
FSA Fine	£29,700,000.00	0.804900952
1% of UBS Pre-Tax Profits	£36,898,950.00	1

¹⁰¹ Complied based on Barclays, 'Barclays PLC: Annual Report 2011'

<[http://group.barclays.com/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobheadname1=Content-Disposition&blobheadname2=MDT-Type&blobheadvalue1=inline%3B+filename%3D2011-Barclays-PLC-Annual-Report-\(PDF\).pdf&blobheadvalue2=abinary%3B+charset%3DUTF-8&blobkey=id&blobtable=MungoBlobs&blobwhere=1330686323829&ssbinary=true](http://group.barclays.com/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobheadname1=Content-Disposition&blobheadname2=MDT-Type&blobheadvalue1=inline%3B+filename%3D2011-Barclays-PLC-Annual-Report-(PDF).pdf&blobheadvalue2=abinary%3B+charset%3DUTF-8&blobkey=id&blobtable=MungoBlobs&blobwhere=1330686323829&ssbinary=true)> accessed 12 December 2012, FSA, 'Final Notice: Barclays Bank PLC' <<http://www.fsa.gov.uk/static/pubs/final/barclays-jun12.pdf>> accessed 10 December 2012, Commodity Futures Trading Commission, 'CTFC Orders Barclays to pay \$200 Million Penalty for Attempted Manipulation of and False Reporting concerning LIBOR and Euribor Benchmark Interest Rates' <<http://www.cftc.gov/PressRoom/PressReleases/pr6289-12>> accessed 11 December 2012 and Department of Justice, 'Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Rate and Agrees to Pay \$160 Million Penalty' <<http://www.justice.gov/opa/pr/2012/June/12-crm-815.html>> accessed 11 December 2012

¹⁰² 1 USD = 0.6422 on date of fine: 27 June 2012

¹⁰³ Complied based on UBS, 'UBS: Annual Report 2011' <http://www.static-ubs.com/global/en/about_ubs/investor_relations/annualreporting/2011/_jcr_content/par/teaserbox_6c86/teaser_a_cb3/linklist/link_9f50.228736590.file/bGluay9wYXRoPS9jb250ZW50L2RhbS9zdGF0aWMvZ2xvYmFsL2ludmVzdG9yX3JlbGF0aW9ucy9hbm51YWwyMDExL0FSMjAxMV9lLnBkZg==/AR2011_e.pdf> accessed 12 December 2012 and FSA, 'Final Notice: UBS AG' <<http://www.fsa.gov.uk/static/pubs/final/ubs-ag.pdf>> accessed 12 December 2012

¹⁰⁴ 1 CHF = 0.6897 GBP on date of profits published: 15 March 2012

Table 3 HSBC¹⁰⁵

		% of HSBC 2011 Pre-Tax Profits
HSBC 2011 Pre-Tax Profits	\$21872000000	100
US Fine (USD)	\$1900000000	8.686905633
1% of HSBC 2011 Pre-Tax Profits	\$218720000	1

Table 4 FSA Enforcement Action and Fines¹⁰⁶

Year:	Total Fines	Number of Fines	Average Fine	Final Notices
2002	£7,444,000	9	£827,111.11	16
2003	£10,975,000	17	£645,588.24	50
2004	£24,769,000	32	£774,031.25	86
2005	£16,965,860	21	£807,898.10	47
2006	£13,309,143	27	£492,931.22	205
2007	£5,341,500	24	£222,562.50	148
2008	£22,706,526	51	£445,226.00	220
2009	£35,005,522	42	£833,464.81	181
2010	£89,121,281.50	80	£1,114,016.02	253
2011	£66,144,839	60	£1,102,413.98	146
2012	£150,260,756	49	£3,066,546.04	151

¹⁰⁵ Complied based on HSBC, 'HSBC Holdings PLC: Annual Report and Accounts 2011' <http://www.hsbc.com/1/content/assets/investor_relations/hsbc2011ara0.pdf> accessed 13 December 2012 and BBC News, 'HSCA To Pay £1.9bn In US Money Laundering Penalties' <<http://www.bbc.co.uk/news/business-20673466>> accessed 12 December 2012

¹⁰⁶ Complied based on information extracted from: FSA, 'Enforcement Notices and Application Refusals' <<http://www.fsa.gov.uk/library/communication/notices>> accessed 10 December 2012 and FSA, 'Fines Table' <<http://www.fsa.gov.uk/about/media/facts/fines>> accessed 10 December 2012

Figure 2

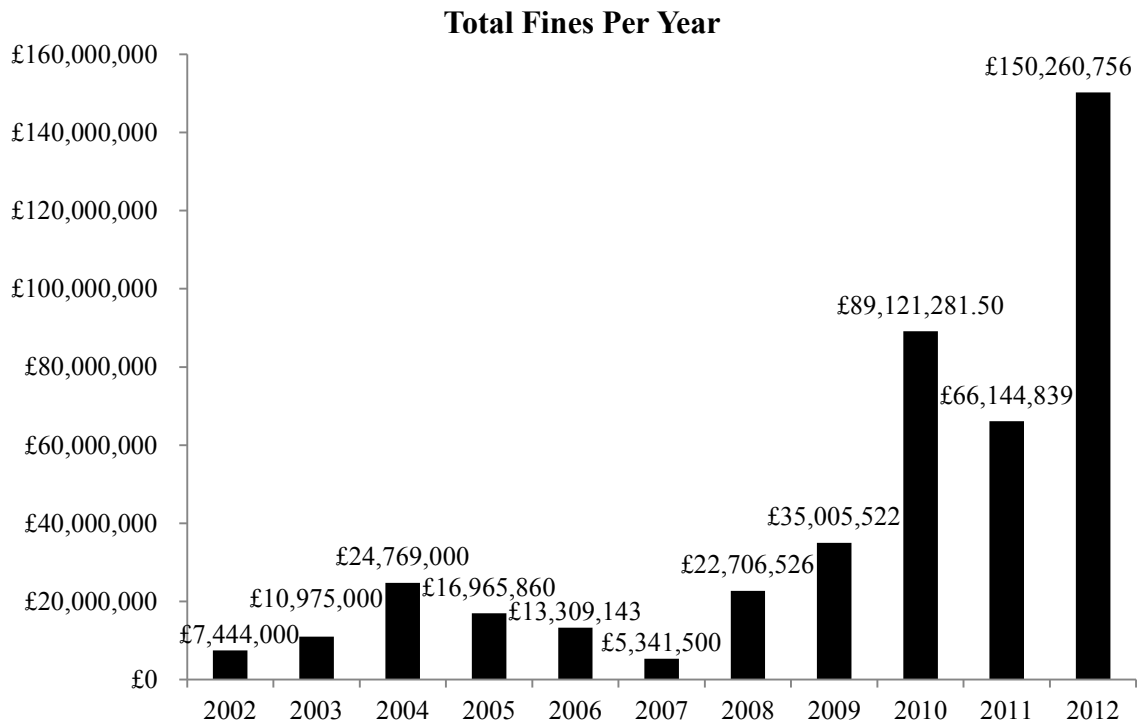


Figure 3

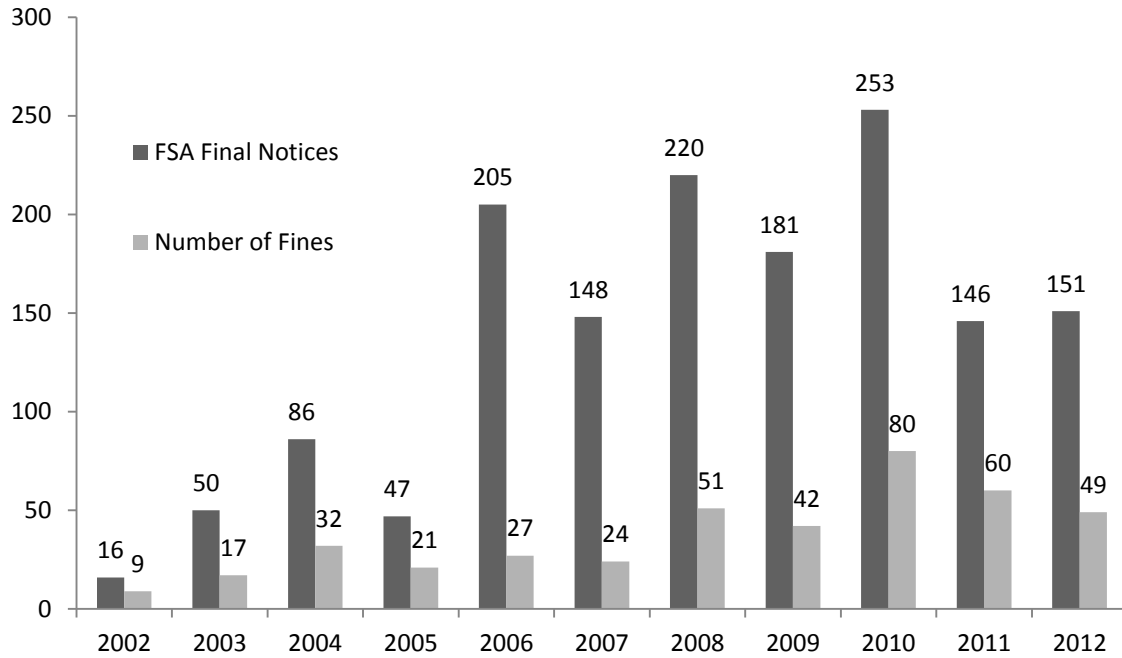
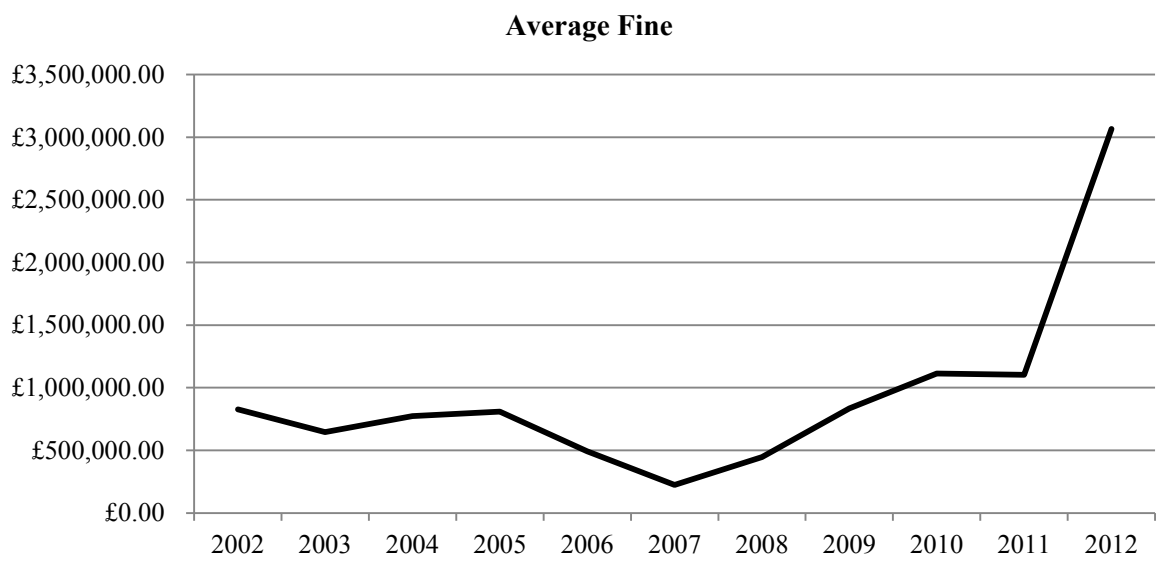


Figure 4



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