To catch a thief, ask a thief: reinforcing sanctioning regimes in financial services, a response to a Communication of the European Commission

Summary

This response to a Communication of the European Commission on ‘reinforcing sanctioning regimes in financial services’ supports the emphasis placed on more intensive investigation and detection. Sanctions remain hypothetical in the absence of detection, which is unlikely without serious investigation. Therefore, in moving towards a harmonisation (upwards) of sanction levels, consideration should be given to market participants' perceptions of likelihood of detection, as well as their perceptions of what sanctions would be dissuasive if applied. These questions can be explored empirically, through methods of social and criminological research – including interviews with rule-breakers who have been detected and have decided to cooperate, and with rule-breakers who have not been detected but who have decided to come forward and may be found in leniency programmes (where these exist). This response also points to some difficult issues about sanctioning, reputational damage and proportionality in relation to firm size.

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Author

Prof Dr Nicholas Dorn, EUR, Postbox 1738, DR 3000, Netherlands. dorn@frg.eu.nl
Introduction

In December 2010, in the context of difficulties experienced by some Eurozone member states, which follow on from and are in part the consequences of the crisis in global financial markets, the European Commission published a Communication on reinforcing sanctioning regimes in the financial services sector.¹

The Communication mentions four criteria to be taken into account in establishing effectiveness, proportionality and dissuasiveness of administrative measures or sanctions: the benefit for the authors of the infringement; their financial strength (for example, turnover or income); their cooperativeness or otherwise; and the duration over which the behaviours occurred.²

There is no doubt that action along the lines discussed in the Communication is merited, in relation both to legal and natural persons, for all the reasons that are set out in the Communication, explored in the studies that underpin it, and also set out in the wider regulatory, legal and scholarly literature on the financial regulation and enforcement. The question remains how to establish appropriate forms (modalities) and levels (intensities) of measures/sanctions.

This response focuses on three issues:
- the importance of detection, well-flagged in the Communication and deserving strong support
- the approach to sanctioning in relation to firm size, where the considerations put forward in the Communication may need fine-tuning
- the question of how to gather further information for policy making in this difficult area, so that sanctioning can become increasingly evidence-based.

The present writer addresses these issues as a sociologist and criminologist working in a law school,³ publishing on these and related issues.⁴
(1) Effective and dissuasive sanctions? First, detection: a collective endeavour

First, the Commission points out that, as well as considering the duration over which the behaviour took place, and the financial gain obtained by natural and/or legal persons, sanctioning policy should also be guided by ‘the assumption that a rational market operator would take into account the likelihood of detection’ (Communication, p 12):

In order to dissuade a rational market operator from breaching the law, the possibility that a violation would remain undetected should be offset by a fine that could reasonably be considered to exceed the potential financial benefits that could be gained from a violation, even where those benefits are not capable of calculation. This would be on the assumption that a rational market operator would take into account the likelihood of detection in deciding whether to commit an offence, and that not all infringements would be actually detected.

This may be regarded as the most important issue raised by the Communication. In order to maintain dissuasiveness, the proportionality of sanctions should be considered in relation to the (un)likelihood of detection and in relation to the financial gain. It is reasonable to assume that here, as in other areas of life, actors discount sanctions when they consider that investigation is unlikely to occur, or is likely to be desultory, thus unlikely to result in detection and actual application of the sanction. To take as a concrete example the Madoff case: for many years, investigation was desultory, detection was absent and enforcement absent (this being reinforced in the case of Mr Madoff because he was a pillar or the financial community). The Ponzi nature of the operation only came to light because some investors, having suffered loses elsewhere on account of the financial crisis, sought return of their funds from Madoff. Had the crisis not occurred, then Mr Madoff might have been able to continue operating his Ponzi scheme.

What is relevant for dissuasion is a sense within the markets that robust investigation and detection are being prioritised by the regulatory and other authorities within member states – and that such action is being actively supported by market actors generally. Not just lone whistleblowers; not just cooperating individuals; but also a wider market partnership and cooperation in regulatory surveillance. Dissuasion is closely related to detection, and is a collective endeavour of the markets, as well as being an individual or firm-level process.
In broad-brush terms, the EU should:

- increase not only the likelihood of detection but also, and more importantly, market participants’ perceptions of this;
- as long as detection rates and market participants’ perceptions thereof remain (unacceptably) low, compensate for this by higher sanctions;
- if and when detection levels might improve, be ready to re-assess levels of sanction and possibly lower them;
- fine-tune measures/sanctions in relation to firm size, where the issues are more complex than acknowledged in the Communication (see section 2 below);
- in order to do all the above, the EU should be able to gauge market participants’ perceptions of detection, such information being a key element in the evidence base for policy on measures/sanction in financial markets (section 3 below).

(2) Proportionality in relation to firm size: market discipline and its limits

The Commission raises in its Communication of December 2010 some questions about the relationship between sanctions and ‘financial strength of the financial institution’ (p 14). This is a delicate but important issue for several reasons.

The remedial actions of states in reaction to the financial crisis have tended to result in further concentration in some sectors, particularly in retail and commercial banking. This exacerbates ‘too big to fail’ (or ‘too systemically connected to fail’) problems, with the associated issues of moral hazard. A possible implication is that, whereas the authorities might accept the failure of a small or medium size firm (as a result of reputational and financial damage following regulatory investigation and enforcement), failure of a very large (systemically connected) firm would not be seen as being acceptable. So, alongside ‘too big to fail’, we may not arrive at ‘too big to prosecute’, however we could arrive at ‘too big not to settle with’.

By contrast, according to the research of John Armour and colleagues at Oxford University, there could be a disproportionately strong threat hanging over smaller firms (and individuals), compared to the threat hanging over larger firms. To this can be added the research finding that, when a firm is sanctioned for behaviour damaging its trading partners, then the reputational damage – as measured in terms of decline in its share (equity) price – may under some circumstances greatly exceed
the financial value of the regulatory sanction (by a factor of ten or so, some research suggests). This reputational damage appears to be greater for small firms.\textsuperscript{7} The present author wonders if this differential reaction has to do with small firms being easily sidelined by other market actors, whilst market actors have little choice but to go on trading with very large firms, due to their dominant position.

This ‘knock on’ effect has a bearing on the question of how to conceptualise the most appropriate relationship between levels of sanctions and firm size (or turnover or profit levels). A level of sanction that is calculated by reference to firm size or turnover could have a disproportionately greater effect (via reputational spillover effects) on small firms, possibly causing their demise. Larger firms would be less affected, in the sense that the effect of reputational damage as evidence in their share prices would be proportionally less. If proportionality is the aim, then the Commission might wish to propose a more lenient sanction/turnover ratio for smaller firms, and a more punitive sanction/turnover ratio for bigger firms.

In short, doubt is cast on any implicit or explicit assumption that there should be a linear relationship between level of sanction and firm size, turnover or profits. Instead, sanctioning metrics should be fine-tuned in the light of their broader probable effects (sanction intensity + market reaction).\textsuperscript{7}

We may add that, if smaller firms are put out of business by a combination of sanctioning and reputational damage, then their assets may be bought cheaply by already-large firms. Large firms could have many more incentives to blow the whistle on small firms’ misbehaviour, than small firms have in relation to large firms’ misbehaviour. In short, sanctioning and firm size may need to be viewed through the lens of competition, as well as through the lens of integrity.

There is a further complication. Reputational damage involving serious financial damage to a firm (as reflected in share price) arises most commonly when the behaviour of a firm is such as to hurt its trading partners. When however the behaviour harms third parties (eg, consumers), and does not hurt trading partners,

\textsuperscript{7} In the longer run, the possibility arises that the authorities might wish to set sanctions in two stages: first, a state-imposed sanction at a minimum level, followed after some months by a second or further sanction, set in the light of the market’s own discipline (or lack thereof). This would take some of the guesswork out of sanctioning, reducing both the danger of driving firms into insolvency, and the danger of under-sanctioning when the market itself fails to impose any reputational/trading ‘sanctions’ of its own. This innovative policy possibility deserves careful examination, scenario-playing and consultation.
then reputational effects as evidenced by share price declines are considerably less or even lacking. As Armour et al put it: ‘In one case ([harm caused to] trading partners), reputation massively reinforces the penalties imposed by regulators; in the other ([harm caused to] third parties) it negates or reverses them. Regulatory penalties that do not recognize these differences will be seriously excessive in the first case and deficient in the second’. The implication may be that the Commission should propose stiffer sanctions for forms of behaviour that hurt consumers but are not disciplined by trading partners in the market (because they do not offend or hurt them).

In summary, sanctioning strategy needs to be driven by consideration of detection risk (higher sanctions for seldom-detected behaviour); firm size (much higher sanctions for larger firms); and whether the behaviour complained of hurts trading partners (in which case the market may considerably amplify the sanction, in which case the sanction would need to be low, to avoid disproportionate effects) or ‘only’ hurts the public-at-large or the state (in which the market may not much amplify the sanction, so the sanction would need to be high).

(3) Evidence-based sanctioning? “What works?” and who to ask

There exists something of a consensus amongst stakeholders in policy, supervisory and market milieux that sanctions should be harmonised upwards. European legislators rightly seek to pitch sanctions at levels that are effective, proportionate and dissuasive, in the sense of having the power to minimise harmful behaviours. This raises the important issue of the effectiveness of both detection and sanctioning. How can effectiveness be estimated – in other words what is the information strategy needed to reach the objectives set out in the Communication?

An evidence-based methodology is required for establishing appropriate modalities and levels of sanctioning. We therefore draw attention here to a practical, research-based approach. A version of the following methodology was developed by the consultancy firm John Howell and Co., in the context of work on priority-setting carried by the Financial Services Authority in the United Kingdom, in 2008. This line of work was unfortunately overshadowed by the crisis-management atmosphere actions triggered by recognition of the financial market crisis: it is recovered here and re-offered at European level.
Data can be obtained from market participants who come into contact with wrongdoing. In particular:

- Interviews with **rule-breakers who have been detected and who have decided to cooperate with the authorities** (through guilty pleas and/or giving evidence against others) – asking them for their perceptions of detection (its modalities, power and limitations).
- Interviews with **rule-breakers who have not been detected but who have decided to come forward** and to enter leniency programmes (where available) – asking them as above.
- Interviews with **victimised persons/firms** – asking them why their suspicions were not aroused, or why if their suspicion were aroused they nevertheless went ahead instead of contacting the authorities, so undermining timely detection.
- Interviews with **resistant persons/firms** – those who were targeted but did not become victims, and some of whom did approach the authorities, so aiding detection.
- Interviews with risk, audit, compliance and security professionals.

Each of these categories of persons can report their **perceptions of the likelihood of detection**, in relation to the sanctionable behaviours with which they are familiar (for example insider trading, fraudulent misrepresentation…). Also they can give **reasons why** they think detection would be likely or unlikely. For example, victimised persons/firms can explain the circumstances in which they allowed themselves to be victimised, whether they had any suspicions but ignored them, so not approaching the authorities (reducing the detection rate). Rule-breakers can explain at what point, and why, they perceived the likelihood of detection to be such that that decided to declare themselves to the authorities. **Qualitative research** is obviously as important here as quantitative.

The logic is, if you want to understand market participants’ perceptions of the risk of detection (and hence risk of being sanctioned), ask them. Theoretically, one might also ask staff of regulatory and enforcement agencies, however they would be better defined as being the customers for independently-provided information, not as the providers. Alternatively, one might try to ‘model’ detection in a statistical manner, although neither the models nor the statistics are up to the task. Happily, however, it is much simpler, more direct and also **more relevant** to ask those who have been at
risk of detection and who can report on their own perceptions of that risk: it is after all the perceived risk of detection that bears upon dissuasion.

Conclusions

This paper, in response to the European Commission’s December 2010 on reinforcing sanctioning regimes in the financial services sector, has drawn out three main points. These complement the analysis offered by the Commission.

1. Consider market participants’ perceptions of detection risk

Detection – which requires robust investigation – is a vital ingredient in any sanctioning regime (as illustrated in a negative manner in the run-up to the financial crisis, when investigation was lax and variable). Thus the emphasis placed in the Communication on investigation and detection is to be welcomed and must be underlined.

The ideal relation between the likelihood of detection and the intensity of sanctioning should be an inverse one. When detection is low, sanctions should be higher, in order to try to compensate for the unlikelihood of detection. However, when detection is very low or even absent for some categories of action, then sanctioning is absent and the prospects for dissuasion are zero, regardless of the theoretical level of sanctioning.

Theoretically, one could enhance prevention/dissuasion purely through more robust investigation and detection, without any upward harmonisation of sanctioning. That is not being advocated here – however the point is made that high-level sanctions without detection are useless in an instrumental sense (even if they may sometimes serve symbolic functions). On the other hand, in the unlikely (indeed preposterous) scenario in which detection approaches 100%, then sanctions could be set at not much more than the benefit gained by the malefactor. We are a long way from that, which is why both detection rates and available sanctions have to be raised.
2. Consider market self-discipline as triggered by sanctioning

The ways in which financial markets discipline their participants have to be taken into account when calculating sanctioning. For commercial entities, reputational damage can be conceptualised in terms of financial consequences within the marketplace (as measured for example in terms of share prices). In certain circumstances – when for example the behaviour of firms hurts their trading partners – then the firm may be punished by the market (as trading partners would prefer to do business with someone else), as well as being punished by the authorities. Such damage may be greatest for smaller firms, some of which may fail as a result. However bigger firms are more able to ‘brush off’ the reputational damage, due to their dominant positioning in the market (too big not to do business with, hence ‘too big to fail’ in an unexpected sense).

An implication for proportionality (taking together public and market sanctions) and for dissuasiveness is that the relation between sanctioning and firm size should not simply be a linear relation, it should be more greater.

Reputational damage may also be slight when the behaviour hurts distant third parties or hurts the integrity of markets as a whole (as distinct from hurting firms’ direct trading partners). An implication for proportionality here is that apparently ‘victimless’ financial market offences – for example, insider trading – should attract higher levels of sanctioning than offences that hurt direct trading partners. Clearly, sanctioning spillover mechanisms need to be carefully considered when harmonising regulatory sanctioning regimes. Information sources on this include firm-level case studies, comparative studies of firms’ share price movements following sanctioning, and qualitative research with market participants.

3. Ask the bad guys

Questions about effectiveness, proportionality and dissuasive power of perceived detection, and of potential sanctions, can be explored through methods of social and market research, as set out above in this response. Small-scale qualitative methods can be implemented quickly; they can therefore inform the debate on sanctioning regimes in the financial services sector.
Key sources of information on financial market misbehaviour include market participants: notably, offenders who have come to fear detection and so have ‘turned themselves in’ (and may enter leniency programmes where these exist), and those who have been detected and have decided to cooperate.

These and other market participants can be invited (through their legal representatives) to participate in in-depth research, explaining what their assumptions had been about the likelihood of detection. For example:

- What was it about the whole situation in which rule-breakers acted that initially made them think they would not be detected, and what changed to make them think that the possibility of detection had risen to an unacceptable level?
- To what extent did such changes of mind occur in relation to perceptions of and fears about possible investigations coming closer and so detection becoming more likely – and to what extent in relation to changes in personnel, policy or governance within the firms concerned?
- Also, what were the concerns in relation to the interplay between sanctioning and reputational damage? In what circumstances do various categories of market participants conceptualise the risk of detection primarily (or even solely) in relation to the public sanctioning that may follow detection – and in what circumstances may there be also be a perception that significant market-based and reputational damage might follow (tying in with issues in section 2 just above).

An information strategy orientated to such questions would hold great potential for, the development of European policy making for market integrity and stability, yielding information for policy in the short term (as measured in months) as well as long term.

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Notes


2 Communication, heading 4, pp 14-16.

3 Professor of International Safety and Governance (part time), Department of Criminology, Erasmus School of Law, Erasmus University Rotterdam.

4 Author of publications including:
   - __ 2010a, ‘Regulatory conceptions of unacceptable market practices under three policy scenarios’, Journal of Banking Regulation, volume 12, issue 1, December, pp 24-47.
   - __ with Van de Bunt, H, 2010, Bad Thoughts: towards an Organised Crime Harm Assessment and Prioritisation System (OCHAPS), a study conducted by the Erasmus School of Law, Erasmus University Rotterdam, commissioned by WODC, The Hague.


7 Armour et a (op cit, p 25) say as follows: ‘We observe that the penalized firms’ stock prices experience statistically significant abnormal losses of approximately ten times the financial penalties and compensation paid. We interpret the fall in equity market value in excess of mandated payments as the firms’ reputational loss. This is consistent with theories which suggest that revelation of information of misconduct by a firm will cause its trading partners – its customers and investors — to downgrade their assessments of its quality and adversely affect its terms of trade. Consistent with this, the negative share price reactions in our sample are entirely associated with cases where the misconduct involves harm to trading partners, for example, mis-selling financial products and mis-statements in financial reports. Where the wrongdoing affects third parties rather than trading partners (resulting, for example, from failure to comply with rules about money laundering or reporting of trades in other firm’s stocks), there are no statistically significant abnormal returns beyond the amount of financial payments required.’

8 Ibid.
