What should be the relative emphasis of regulators on prevention v. identification of wrong doing and penalties?

Rhys Casey and Liam Hennessy*

Paper delivered at the Australian Centre for Financial Studies' 24th Melbourne Money & Finance Conference 2019 on 23 July 2019

I. Introduction

> *Justice must always question itself, just as society can exist only by means of the work it does on itself and on its institutions*. (M. Foucalt)[1]

Australia is experiencing a surge in regulatory activity, both in the scope of new laws and the enforcement approach of its key corporate regulators. In the authors' view, the shift started before the advent of The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (**Commission)**. It is an accepted fact now. ASIC has propounded its well-publicised "*why not litigate"* approach and APRA has announced a (less well-publicised) *"constructively tough"* appetite to enforcement.

The regulators' newly hawkish approach to enforcement – and willingness to employ novel monitoring techniques; for example, placing psychologists in the boardroom - raises a number of important issues. How far should the pendulum swing from non-punitive means of promoting model corporate conduct to punitive means? This article will focus on that question in the context of the financial services industry and put forward, with reference to domestic and overseas experiences, that the pendulum should not swing too far from a utilitarian perspective.

II. Basic theory

The deterrent effect of punishment has been debated for millennia; Aristotle in the 4th century BC spoke to humanities' refrain from evil due to punishment alone.[2] Naturally it translates to the sphere of corporate financial regulation, and its associated economic and political overlays. Shapiro and Rabinowitz,[3] wrote nearly two decades ago about the suffocation of America because *"regulators zealously enforce detailed rules in circumstances where enforcement is counterproductive, unfair, and even nonsensical"* and identified that a mixture of cooperation and punishment is optimal; finding the ideal combination was difficult. Like many others, the article followed Ayres and Braithwaite's famous "*enforcement pyramid"* theory[4] which set out the relationship between regulatory techniques – self regulation, enforced self-regulation and command & control regulation (including punishment) in ascending order of magnitude. They argued that that no one technique alone should be overly preferred in achieving regulatory aims.

Within this broad construct are subordinated considerations, including whether the legal framework being operated within by the regulator is comprised of principles-based laws or compliance-based laws (or commonly both). There are advantages and disadvantages to each; Black argues that

---

* King & Wood Mallesons. The authors would like to thank the reviewers William Waldron, Christopher Stackpoole and Adam Caldwell. Any errors and omissions belong to the authors.

[1] M Foucault, "Vous Êtes Dangereux" in Libération (Paris, 30 June 1983; repr. in Didier Eribon, Michel Foucault, 1989; tr. 1991).
[2] Aristotle, Nicomachean Ethics, bk. 10, Ch. 9.
[3] S Shapiro and R Rabinowitz, *Punishment versus Cooperation in Regulatory Enforcement* (1997) 29 Admin L Rev 713
[4] The model was first put forward by Braithwaite in J Braithwaite, *To Punish or Persuade: Enforcement of Coal Mine Safety* (1985). See also B Fisse and J Braithwaite, *Corporations, Crime and Accountability* (1993); C Dellit and B Fisse, 'Civil and Criminal Liability Under Australian Securities Regulation; The Possibility of Strategic Enforcement' in G Walker and B Fisse (eds), *Securities Regulation in Australia and New Zealand* (1994), 570.

frameworks emphasising the former shifts the regulatory focus from process to outcomes, which then permits firms to identify the most efficient way to proceed.[5] It has the potential to create confusion in the absence of clear guidance.

This article proceeds on the basic correctness of Ayres and Braithwaite's theory (i.e. a mixture of enforcement tools yields the best outcomes), the authors' assessment that Australia is introducing increasingly significant principles-based regulation (borrowing from the UK) and comprises a point-in-time consideration of Australia's regulatory environment and comments on the way forward.

III. Australia's nexus point

Australia's financial services regulatory landscape is at nexus point. Broadly, there are two underpinnings; *first*, the new (or expanded) relevant laws which have or are to come into effect and *second*, the regulators' recent emphasis on, and increased capacity to conduct, punitive enforcement.

In terms of the relevant laws, three examples can be given. The first is the Banking Executive Accountability Regime (**BEAR**), which this month come into effect for small and medium ADIs (it came into effect for large ADIs in July 2018), and is based off the UK Senior Managers' & Certification Regime (**SMCR**). At its core, BEAR involves the division of all key responsibilities across the firm between senior executives / directors (e.g. internal audit function), imposition of broad principles-based obligations (e.g. "*deal[*ing] *with APRA in an open, constructive and co-operative way*") and liability for the ADI and individual where they fail to take "*reasonable steps"* to discharge their obligations. Part and parcel of Western regulatory systems' push to improve culture in the financial services industry by targeting individuals (in the US, primary reposed in the famous *"Yates Memo"* which mandates firms to provide information about individuals to qualify for co-operation credit), one of the notable outcomes of the Commission was a commitment from the Morrison Government to permit ASIC to duly administer BEAR and to extend the same to all AFSLs. A supercharging of the regime, which brings it closer to the SMCR in terms of scope and application.

The second is the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* (**Penalties Act**) which came into effect on 12 March 2019. The Penalties Act amended various pieces of legislation that ASIC administers to increase penalties for criminal and civil offences and expands the scope of the civil penalty and infringement notice regimes. As one example, in relation to s.13 of the *Insurance Contracts Act 1984* (Cth) (**ICA**) which implies a duty of utmost good faith into insurance contracts, the Penalties Act inserted the following section (s.13(2A)):

> *"(2A) An insurer under a contract of insurance contravenes this subsection if the insurer fails to comply with the provision implied in the contract by subsection (1).*
> *Civil penalty: 5,000 penalty units* [$1.05M as at today's date]*."*

The civil penalties listed in this provision are the maximum applicable to individuals. Under s.1317G of the *Corporations Act 2001* (Cth), amended by the Penalties Act, the maximum penalty for a corporation is either of: a) the greatest of ten times the maximum penalty applicable to an individual i.e. $10.5M; b) if the court can assess the benefit derived or detriment avoided from the contravention, three times that amount; or c) ten per cent of the annual turnover of the body corporate for the 12 month period ending in the month that the body committed, or commenced committing, the civil contravention, capped at 2.5 million penalty units ($525M). Long sought for by ASIC – and thankfully without a retrospective operation - the scope of these penalties now mean that its enforcement stick is comparative to that of the US DOJ and UK FCA.

The third example is ASIC's product intervention power (again, which will be familiar in overseas jurisdictions), which imposes design and distribution obligations on financial services firms which come into effect in April 2021, and permits ASIC to intervene and take temporary action where

[5] J Black, *Principles Based Regulation: Risks, Challenges and Opportunities* (2007) London School of Economics and Political Science, 3.

financial and credit products have resulted in or are likely to result in, significant consumer detriment. These powers became live in June 2019. At the time of writing, ASIC was publicly consulting on both the proposed administration of its new power - which requires a consultation before each use – and its proposal to use the power to intervene in the short term credit industry.

In terms of the emphasis on punitive enforcement by Australian regulators, this was a pervasive theme throughout the Commission. Commissioner Hayne stated in his final report:

> *"The conduct regulator, ASIC, rarely went to court to seek public denunciation of and punishment for misconduct. The prudential regulator, APRA, never went to court."*

Understandably, it has been a continuing theme adopted by the regulators thereafter. As ASIC Chair James Shipton told the Senate Committee in February 2019, at the time citing 15% rise in enforcement investigations since February 2018 (which percentage rose to 21% as at June 2019):

> *"ASIC is very focused on enforcement and litigation…Corporate Australia should know that ASIC has the very clear will to take wrongdoers to court. As the Royal Commission found, that is what Australians expect of their Regulator. And that is what ASIC will deliver"*

This aggressive approach has been allied with additional resources[6] and willingness to take arguably novel approaches – at least in the Australian context. For example, embedding a psychologist in the boardrooms of select companies with the outcome of improving corporate culture. It is safe to say that the idea has been initially controversial, with issues of reporting lines, confidentiality and the risk of stilted debate being raised in opposition. Another example is ASIC's "*close and continuous*" monitoring program, which involves regularly placing ASIC staff onsite in major financial institutions to monitor their governance and compliance with laws. A not uncommon occurrence in the US landscape, in the first two months of its operation (31 October to 31 December 2018), ASIC's staff had conducted more than 100 onsite interviews of banking staff at all levels.

IV. Where to now?

That Australia's regulators will concentrate more on the upper level of Ayres and Braithwaite's enforcement pyramid (i.e. punitive enforcement) with their new powers and resources appears clear. Nor is that necessarily a bad thing *per se* in light of the Commission's findings. As Shapiro and Rabinowitz identified, finding the ideal balance is difficult. And highly specific to the factual and legal framework. What would be a poor outcome for Australia's financial services industry is if the lower levels of the enforcement pyramid (i.e. self-regulation) become anaemic through less engagement, either in volume or quality, from the regulators in terms of their expectations.

This is particularly so given the aforementioned shift to more principles-based regulation and greater focus on individuals to achieve regulatory outcomes; BEAR is a perfect example of both. Given the wide field in which ASIC will have to operate once it is in dual control of this regime, and the serious consequences for individuals, it will behove ASIC (separate to APRA) to clearly and in as much detail as possible set out its expectations. For example, will the obligation to deal with it in "*…in an open, constructive and co-operative way*" put pressure on firms to waive legal professional privilege, or erode the protections against self-incrimination? One would expect not, though that has not been the position of comparable foreign regulators in similar circumstances (e.g. the UK Serious Fraud Office in relation to whether or not it will offer Deferred Prosecution Agreements). Comments made by ASIC's enforcement chief, Daniel Crennan QC, in June 2019 (reminiscent of some overseas rhetoric) strike a foreboding note in this regard:

[6] In April 2019, the Morrison Government announced $400 million in additional funding to give effect to ASIC's goals.

"[parties concerned in actions] *should not be doing is engaging in years of litigation, using an asymmetry of funding to engage in endless interlocutory stoushes with ASIC and then look to settle on the courthouse steps."*

To be clear, it is not the authors' view that the pendulum has swung too far just yet. There is much to appreciate about the volume and quality of consultation that both ASIC and APRA are currently undertaking with respect to their new powers, for example with respect to the aforementioned product intervention power. And in respect of the level of public engagement expressing their views. One example is ASIC Chair James Shipton's useful clarification of the "why not litigate" mantra i.e. it does not mean litigate everything, on the back of his clear position statement:

"At the same time, we are looking to use the full extent of our new penalties and powers through the prism of 'why not litigate'"

The authors' view is, however, that there is the real potential for the pendulum to swing too far given the confluence of an at-times febrile political and public debate on the financial services industry, the recent new (or increased) enforcement powers of the regulators which have yet to be road-tested and their self-stated keenness to wield them. That would be an unfortunate outcome, and one that serves neither the regulators nor the regulated. At least two UK examples are illustrative here.

V. Overseas experience

The first example, is the UK Financial Conduct Authority's (**FCA**) proposals on the treatment of the legal function under the SMCR regime. In relation to that longer-standing regime (itself built on a similar predecessor regime; the "Approved Persons Regime"), from whence BEAR was inspired, it is sufficient for the purpose of this article to observe that that regime requires senior managers to set out their responsibilities in writing, comply with certain conduct expectations insofar as their sphere of responsibility is concerned and that personal liability may attach to them where they do not meet those expectations.

The UK SMCR went live for select firms (e.g. banks) in March 2016. It was extended in 2018 to all FCA-regulated firms. Since its inception, one particularly vexing question has been where the legal function was caught. Should a firm's General Counsels be regulated by the FCA? Is their professional duty of confidence immiscible with their duties under the UK SMCR, which includes a duty to be "*open and co-operative with the FCA and PRA"*. There was appreciable industry uncertainty following which, in September 2016, the FCA released discussion paper DP 16/4 seeking to clarify how and why the legal function is currently captured under the SMCR and to consider whether it should continue to be part of the regime. The discussion paper did not quell the uncertainty; it drew widespread commentary and opposition.

On 29 March 2019, the FCA released its proposal paper regarding the treatment of the legal function (Consultation Paper 19/4). There remain points to be clarified, though it appears that the FCA intends for the Head of Legal function not to be caught in the SMCR. The substance of the decision aside, and difficulty of the issues under consideration (FCA CEO Andrew Bailey stated on 9 April 2018 that it "*isn't an easy question*"), the issue is the timing. Appreciative of the competing demands on the busy and effective regulator that the UK FCA is (and the black swan event that is BREXIT), three years is an appreciable period of uncertainty - and arguable distraction - for firms and interest groups to live with in respect of a new and imposing enforcement regime.

The second example involves the UK Serious Fraud Office (**SRO**). In short, ENRC (a resources company) became aware of bribery allegations, commenced an internal investigation with external legal counsel and then self-reported to the SFO. The SFO then demanded production of a wide array of documents, including the external legal counsel's notes of interviews with current and former employees. ENRC refused on the basis of legal professional privilege, whereupon SFO commenced UK High Court proceedings and was successful in the first instance. The essential rationale underpinning the judgment was that these documents were created before the contemplation of criminal proceedings and as such legal privilege could not apply.

In September 2018,[7] the UK Court of Appeal overturned the decision after the Law Society undertook the very unusual step of intervening as a third party. Paragraph 116 of the judgment held:

> *"It is, however, obviously in the public interest that companies should be prepared to investigate allegations from whistle blowers or investigative journalists, prior to going to a prosecutor such as the SFO, without losing the benefit of legal professional privilege for the work product and consequences of their investigation. Were they to do so, the temptation might well be not to investigate at all, for fear of being forced to reveal what had been uncovered whatever might be agreed (or not agreed) with a prosecuting authority."*

The issue, in the context of this article, is the forewarning. The Court of Appeal considered the SFO's 2009 Self–Reporting Guidelines, which anticipated legal advice being received before the self-reporting process and noted a party may have reason to apprehend prosecution even if there was a lack of *"concrete evidence"*. The SFO Guidelines did include a statement that: "*all supporting evidence including, but not limited to, emails, banking evidence and **witness accounts** must be provided…as part of the self-reporting process*" (emphasis added).

Arguably a regulator's function is not confined to enforcement of the legislative framework over which it has oversight. It includes promoting compliance with that framework through cooperation with and education of industry. Given that reliance on exceptions to legal professional privilege in respect of documents which have been created to conform to self-reporting obligations (being relatively common market practice) would impinge upon the very industry practices that it seeks to promote i.e self-reporting, the SFO's conduct in *ERNC* is arguably such that it has prioritised the means by which it achieves enforcement of contraventions over its broader object of promoting compliance. In circumstances when the industry is uncertain of how to conform with self-reporting obligations without losing the benefits of legal professional privilege, it is incumbent on the regulator to provide guidance on how it will interpret privilege so as to not to deter corporate compliance with mandatory self-reporting obligations.

VI. Conclusion

Writing in respect of the Commission in December 2018, Davis[8] states that:

> *'The view that we would have had better financial sector behaviour if a more "heavy-handed" prosecution-based approach had been followed is, however, an unproven (and probably unprovable) assertion."*

The authors personally agree. What does appear evident though is that Australia's financial regulatory landscape is at a crossroads. With the powers and resources our regulators can now bring to bear on those they regulate, both firms and individuals alike, they need to continue to effectively consult with and instruct the industry as to what their expectations are. To do otherwise runs the risk of creating uncertainty and potentially distracting regulatory outcomes, which yield little consumer benefit.

---

[7] *Serious Fraud Office v Eurasian Natural Resources Corporation* [2018] EWCA Civ 2006.
[8] K Davis, *Banking royal commission: Will banks in the dock always work?* (4 December 2018), Australian Financial Review.