Financial Services User Group's (FSUG)

opinion on

Reinforcing sanctioning regimes in the financial services sector

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1. INTRODUCTION

We welcome Commission's initiative on reinforcing sanction regimes in financial services sector as part of the financial sector reform and as another step to the single market for financial services.

This initiative complements and completes other measures taken for ensuring the soundness and stability of the financial system, such as the recent reform of the supervisory architecture. Efficient and sufficiently convergent sanctioning regimes are indeed the necessary corollary to the new supervisory system.

A harmonised framework of prudential and remedial rules for financial institutions, which should ensure safety, stability and integrity of financial markets, is indispensable for constructing the single market. This requires also a uniform and effective enforcement of EU rules in all Member States, as emphasized by the Communication.

2. GENERAL COMMENTS

Policymakers have a range of interventions available to them – both preventative and remedial: i) policy interventions (information and education, conduct of business rules, product regulation, competition powers, authorisation, fit and proper rules etc), ii) supervision and monitoring, iii) enforcement, sanctions (legal powers, delisting, fines, etc), and consumer redress.

Sanctions are an important part of the financial regulatory system and robust sanctions should be part of a credible deterrence package of interventions deployed to promote positive behaviours and discourage detrimental behaviours.

Robust sanctioning regime means that sanctions have to be effective (efficient measures in ensuring the compliance with the law), proportionate to the gravity of the breach in the law and dissuasive, in order to prevent the future occurrence of the law violations. We agree with all these principles presented in the Communication.

The findings of the study performed on the Member States' financial regulations require immediate remedial actions for:

- establishing consistent sanctioning regimes in terms of types of sanctions (administrative and criminal) and subjects of sanctions;

- aligning, at a meaningful level, the level of sanctions;

- reaching an uniform application of sanctions.

The proposed actions and measures should envisage the better compliance with EU rules, the enhancement of the customer protection and of the market integrity, and the restoration of public confidence in the financial market. Improvement and convergence of the sanctioning regimes should increase effectiveness of the supervisory activities and should contribute to creating a level playing field for the financial service providers in EU.

3. SUMMARY OPINION

Convergence of sanctioning regimes in EU Member States would be beneficial to the safety and soundness of the financial markets, would contribute to ensuring the same level of consumer protection, would raise the level of awareness among the regulators and the regulated parties and would help creating a level playing field for financial service providers.

FSUG believes that, in setting up the standards for national regulators there should be a minimum level of sanction procedures that should be in place in each Member State, while at the same time, the national legal systems should have the opportunity to keep in place above minimum level of sanctions.

At the same time, FSUG believes that, in setting up the standards for national regulators, the following aspects should be taken into consideration:

- in respect of sanctions:
  - the provision of same types of sanctions by range of violation;
  - all types of sanctions in all the financial sectors;
  - the level of sanctions should be meaningful and relevant;
  - sanctions should be clear and well understood by market participants;
  - sanctions should be set up based on the damage produced to the claiming consumers and/or on the size of additional gains produced by the law violation to the entire portfolio of clients and to the size of the firm involved (assets, turnover, equity);
- regarding the level of fines:
  - level of fines to be risk based and proportionate to the detriment caused or to the potential damage and to the complexity and nature of the financial product/ service involved;
  - fines should affect the level of profit and should be efficient. For example, fine should be set up as percentage to the asset base or the annual balance sheet turnover (up to 10 % of annual turnover up to a maximum of 30 % for the most serious offences) or to the equity;
  - fines for individuals should not refer only to the ban on the bonuses, but to their remuneration;
  - fines should be recovered out of profits, not to be included in the costs of products and services and authorities should monitor this and apply additional sanctions in case of breach;
- on recurrence of offences:
  - sanctions should be recurrence-related, with rapidly increasing levels for repeated offences of the same nature;

  - recurrence of individuals' violations or the gravity of their actions should lead up to their suspension;

- regarding the publication of sanctions and warnings:
  - publication of sanctions and warnings, as a rule for all sectors, with anonymity in cases that might affect the market;

- in respect of criminal sanctions:
  - criminal sanctions should be included in all regulations on sanctions;
  - regulations should stipulate the criteria for applying a criminal sanctions;
  - violations of the law of serious nature, that they can involve seriously large amounts of financial resources, can adversely impact the financial viability of an entity, cause massive personal losses to users/consumers and can create a credibility crisis, loss of market confidence for the financial services industry as a whole, should be subject to criminal sanctions;
  - consumers' interest in recovering damage should not be affected by the pursuit of criminal sanctions;

- on whistle blowing:
  - whistle blowing should be provided by regulations on sanctions;
  - each financial services provider should be required by law to promulgate a 'whistle blower's charter';
  - whistle blowers should be offered protection, but not financial incentives (in order to prevent abuse situations);

- regarding cooperation with authorities:
  - offenders who cooperate with competent authorities should themselves receive more lenient treatment, depending on the value and relevance of the information/ cooperation provided, on their contribution to the disclosure or to recovery the damage;

- implementation of standards:
  - implementation of sanctioning standards may require in some Member State the modification of general regulations, not only the financial ones;
  - standard rules should be provided for application of sanctions;
  - legislators should provide to supervision authorities all the necessary legal powers to enforce sanctions.

Detailed opinions are presented in the attachment to this paper.

Annex

OPINIONS ON THE MAIN ISSUES RAISED IN THE COMMUNICATION ON REINFORCING SANCTIONING REGIMES IN THE FINANCIAL SERVICES SECTOR

Q1: Do you agree that more convergence in the types and levels of sanctions applicable to violations of financial services rules could be beneficial to safety of financial markets and better ensure consumers protection? If not, why?

OPINION:

We would welcome an EU legislative initiative to promote convergence and reinforcement of the national sanctioning regimes in the financial service market by setting standards to be followed by national authorities in designing and applying sanctions.

A greater alignment and convergence of the types and levels of sanctions applicable in each Member State in respect to breaches of financial services rules and regulations would significantly contribute to the safety and soundness of financial markets and particularly would enhance consumer/user protection and confidence.

The alignment of the types and levels of sanctions would be a positive development as it could bring similar protection for consumers all over EU and it could support their ability to understand and access products in different EU Member States. Ensuring equal protection is also important in view of promoting workers' mobility – for workers who invest in pension plans in other Member States. In respect to the consumer protection, we consider that consumers have been disadvantaged and have suffered detriment because of the inability of some national governments and regulators to even apply their own already existing weak sanctions, in respect of violation of rules and codes.

The creation of minimum common standards for sanctions at EU level for application by each national competent authority would raise the level of awareness among the regulators and the regulated parties.

More convergence in the types and levels of sanctions applicable to violation of financial services rules would ensure the level playing field for the market, preventing, for example, the migration of capitals to countries with milder sanction regime. There are also views according to which more convergence is better than the status quo but the ideal situation would be a 'full harmonisation' of the sanctioning regimes among Member States. Currently, there are Member States with high levels of sanctions and other countries with very low levels. Even if there will be convergence of sanctions, there remain a risk that those countries with high levels of fines either lower their current levels (as legitimised by EU rules) or nevertheless face the risk of the migration of capitals.

Setting up the same types of sanctions by range of violation would be important also at national level as it would bring consistency throughout different sectors of the financial market.

More important than the types of sanction it is the stipulation of meaningful levels of fines and administrative sanctions would give regulators compelling enforcement powers and act as a powerful deterrent for institutions and executives. Consumers and financial services users would have higher levels of confidence in the institutions and these institutions and their

managements would face more effective deterrence from partaking in or permitting wrong doing.

Regarding the level of pecuniary sanctions, we believe that these would be more effective if they are related to the level of share capital/equity, for legal entities, and to a number of salaries, for individuals. Thus, no periodic adjustment would be needed and the comparison between different sectors of the financial market and between different countries would be easier.

Sanctions should be risk based and proportionate to the detriment caused and complexity and nature of the financial product/service involved. That is, consumers are more exposed/ vulnerable to detrimental behaviours in complex markets so the sanctions should reflect this. Similarly, it could be argued that mis-selling a pension can have a more damaging effect on consumer welfare than mis-selling a very basic savings account.

The mentioned standards should refer not only to types and levels of sanctions but they should also provide a transparent and objective benchmark for the application of the sanctions. This could be helpful in avoiding the supervisors' subjective assessments and further actions against the sanctions and would enhance the fairness of the sanctioning regime by providing sanctions based on the gravity and incidence of the law violations. It would be very useful if these standards could specify, for example, in which cases a sanction is applied to the institution or when to be applied to both institution and individuals (the institution has, in any case, to assume responsibility for the acts of its employee, in our opinion). Currently, it is possible that sanctions are applied only to individuals and this might be subject of negotiations with the supervisor (institutions might 'sacrifice' their employees although the violation was 'systemic' not individual).

Q2. What are the sanctioning powers that you consider more effective/appropriate in the different sectors? In particular, do you think that public warnings/publication of sanctions would be helpful for financial services users? Are there reasons justifying derogations from the publication of sanctions?

OPINION:

We could not assess that some types of sanctions are more effective or appropriate in some sectors than in others. All the types of sanctions should be provided for all the sectors of the financial services market. Fines could be one of the most efficient sanctions in all the sectors of the financial market.

As part of an escalation of regulatory/supervisory action, we are satisfied that, in general, once sanctions have been implemented against an institution, their publication could follow in a designated official State organ and possibly in print media circulating in the area of the institution's operation or online media.

As not all the supervisory authorities have provided in their regulations the publication of sanctions, by imposing this measure the alignment of different sectors should be reached.

In case authorities will publish the sanction applied to financial institutions, consumers could benefit of the information on the sanctions in order to choose the service providers, to purchase financial products or to check if their existing products with that institution or with another are subject to the same type of law violation. Such publication of sanctions will alert the consumer and the public at large that serious breaches of rules has occurred and that it might not be in the consumers best interests to commence or continue to conduct business with such an entity.

Publication of sanctions could have an important impact for the institution in cause and for the entire sector, through the multiplication effect; other institutions could use this as an opportunity to revise their activities and procedures and to ensure the adequate implementation of regulations. The publication of the sanctioned institution's name, although beneficial from consumer protection, could have a negative impact on the reputation of the institution in question, with potential consequences on its financial stability. Under certain circumstances, the individual failure may have systemic effects, undermining thus the financial stability of the system, with consequences on consumers too. Therefore, we agree with the idea that information on sanctions could be anonymous, depending on the gravity of the case and of the supervisory authorities' interests in maintaining financial stability.

Q3. Do you agree that higher levels of fines are necessary to ensure better deterrence? If not, why?

OPINION:

Sanctions should be tough, meaningful and relevant both to the violation and the institution involved in order to ensure that they have a direct impact on financial performance of the firm or financial position of individuals (either directly or by affecting ability to work in the market). Unless sanctions are robust, senior management, shareholders, and market analysts will not pay much attention to them and therefore will not pay enough attention to minimising the type of behaviours that attract tough sanctions. Sanctions should be clear and well understood by market participants and by analysts.

Fines should be sufficiently large to impact on the return/dividend to shareholders in order to leverage the deterrence factor.

Sanctions set up based on the damage produced to the claiming consumers and/or on the size of additional gains produced by the law violation to the entire portfolio of clients (authorities should perform this kind of impact assessment), and to the size of the firm involved should be efficient. For example, fine should be set up as percentage to the asset base or the annual balance sheet turnover (up to 10 % of annual turnover up to a maximum of 30 % for the most serious offences) or to the equity.

Sanctions should penalize more a second or a third offence of the same nature, being on an increasing scale. So, for example, a 1st serious offence might attract 10 % turnover fine, 2nd offence 20 % etc. Alternatively, after a 3rd offence, firms could be suspended from doing business in that category of product.

Administrative fines in respect to executive management and board members who are proven to be responsible for violations should be substantial not only to elimination of bonuses, where they still apply, but to refer to their remuneration (a number of salaries or up to 50 % of the gross remuneration). For individuals, they could be suspended for the most serious offences or for three minor offences.

At the same time, in order not to affect finally the consumers (especially those unprotected by special laws), there should be a rule for not recovering the fines by increasing the costs of the products and services, but out of the profit. The compliance with this rule should be monitored and supervised by regulators which could give additional sanctions for such a bad practice. Therefore, the rule should be complemented with the supervisory authority of regulators in making sure that consumers will not ultimately pay for the sanctions of offending institutions.

The proceeds raised from issuing fines could be used to finance consumer protection and financial education activities e.g. free debt advice.

Q4. For which kind of violations, if any, do you think that criminal sanctions would be more effective than administrative sanctions? Why?

OPINION:

We agree that criminal sanctions send a powerful dissuasive message, therefore there should be included in all the regulations on sanctions. Criminal sanctions serve as an essential dissuasion/prevention and should always be accompanied by professional disqualification.

Another important aspect is that financial regulations, when including provisions on criminal sanctions, don't contain also the criteria based on which a sanction is to be applied. It is also a very high responsibility for the supervisory authorities to engage themselves in penal legal actions; therefore they could be reluctant in implementing this type of sanctions.

It is very difficult to assess which of the violations could be subject of the criminal sanctions or under what circumstances one violation may become subject to criminal sanctions. Nevertheless, violations that merit criminal sanctions on individuals and financial entities should be those of such a serious nature that they can involve seriously large amounts of financial resources, can adversely impact the financial viability of an entity, cause massive personal losses to users/consumers and can create a credibility crisis, loss of market confidence for the financial services industry as a whole. Criminal sanctions should apply to violations such as the wilful misrepresentation /publication of the assets/liabilities/ market sensitive data of the entity, in order to mislead owners/ shareholders/ public/auditors and regulators, insider dealing, etc.

From consumers' point of view, recovering the damage or having the situation corrected is very important and there could be situations when the penal legal action stops the civil actions for recovering the damage. Users should be able to recover damages from institutions independently from criminal proceedings against individuals (criminal responsibility is personal) and from the fact that an employee is the sole responsible subject. This already happens in some legal systems but it should be made sure that it applies everywhere to avoid the kind of situations that you suggest. Then, institutions may recover such damages from offending individuals according to the rules in place in the various jurisdictions.

Q5. What do you think about measures to encourage whistle blowing? Should MS ensure protection of whistle blowers? Should they provide for financial incentives to whistle blowers? If so, under which conditions? If not, why?

OPINION:

Whistle blowing is now an accepted mechanism whereby many types of malfeasance including fraud, embezzlement, bullying, significant misconduct, corruption and more can be brought to the attention of the appropriate authorities for rectification or prosecution.

From consumers' perspective, encouraging whistle blowing might be reasonable if this could prevent, diminish or support the faster recovery of the damages brought to their interests.

Each financial services provider should be required by law to promulgate a "whistle blowers charter" to recognise that it supports whistle blowing and that the whistleblower will enjoy anonymity and protection against retaliation. An example of such legislation is the Public Interests Disclosure Act in the UK.

An insider who acknowledges illegal matters should not become an accomplice to the respective violation by keeping silence, but he needs protection so that the situation doesn't turn against him. The legal framework should also contain provisions preventing the use of 'whistle blowing' in an abusive matter, such as no financial incentives for whistle blowers. This would prevent abuses or a culture of reporting niceties or minutiae for reasons beyond the aim of the rules that inform the supervision of the financial sector.

Q6. Do you agree that offenders who cooperate with competent authorities should be granted a more lenient treatment in terms of sanctions? If so, under which conditions? If not, why?

OPINION:

In principle, we support the concept that offenders who cooperate with competent authorities should themselves receive more lenient treatment.

Consumers would appreciate to reduce authorities' expenses with following up and investigating the matter and to have a faster and more significant recovery of the losses/damages produced by breaching the law. In case that the offenders' cooperation results in the above mentioned effects, it seems reasonable that they are treated less harshly in terms of sanctions.

The degree of leniency and its conditions among others should be modulated by the value and relevance of the information/ cooperation provided, whether damage to the entity has been ameliorated, whether successful legal prosecutions have been achieved and the extent of culpability of the whistleblower him/herself.

OTHER COMMENTS

1. We would like to draw attention that initiative of aligning the types and levels of sanctions could exceed the financial regulatory framework as some Member States could have a general regulation on sanctions that would need to be amended too (Romania's case, for example).

2. Financial products are highly standardised; therefore a breach of the law under a contract has to produce effects on all the contracts of the same type. Therefore, the law should provide the rule that once a violation of the law is ascertained in some particular case, the financial institution has the obligation to apply supervisor's resolution on the entire portfolio of similar contracts.

3. Sanctions should be enforceable; legislators need to ensure that regulators have the necessary legal powers to enforce sanctions or else they run the constant risk of legal challenge from well-resourced industry.

4. The communication and consultation does not address or concern sanctions against Credit Rating Agencies as they will be exclusively supervised by the European Securities and Markets Authority. However, we think that the FSUG should be given the opportunity to comment on those too.