

A stylized world map in shades of orange and yellow, overlaid on a grid of latitude and longitude lines. The map is centered on the Atlantic Ocean, showing the Americas on the left and Europe and Africa on the right.

# Credible Deterrence In The Enforcement Of Securities Regulation

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This paper reflects the collective experience and expertise of the member jurisdictions of IOSCO's Committee 4 on Enforcement and the Exchange of Information.

The factors referred to in this paper highlight useful enforcement practices and powers adopted by various regulatory authorities around the world to promote and encourage credible deterrence of misconduct.

A reference, in this paper, to a specific regulator does not mean other regulators have not adopted similar powers or practices.

This paper has not been prepared, nor is it intended for use as either an assessment or benchmarking reference for securities regulators.

Certain authorities may consider rule proposals or standards that relate to the substance of this report. These authorities provided information to IOSCO or otherwise participated in the preparation of this report, but their participation should not be viewed as an expression of a judgment by these authorities regarding their current or future regulatory proposals or of their rulemaking or standards implementation work. This report thus does not reflect a judgment by, or limit the choices of, these authorities with regard to their proposed or final versions of their rules or standards.

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# Credible Deterrence in the Enforcement of Securities Regulation

## Introduction

1. The purpose of this paper is to identify and promote awareness of those factors that may credibly deter misconduct in securities and investment markets.
2. Misconduct in securities and investment markets has profound and far-reaching consequences for all levels of society. Consumers, investors, capital markets, institutions, national economies and global financial systems are all impacted when the integrity of securities and investment markets are undermined by misconduct.
3. Deterrence is credible when would-be wrongdoers perceive that the risks of engaging in misconduct outweigh the rewards and when non-compliant attitudes and behaviours are discouraged. Deterrence occurs when persons who are contemplating engaging in misconduct are dissuaded from doing so because they have an expectation of detection and that detection will be rigorously investigated, vigorously prosecuted and punished with robust and proportionate sanctions.
4. Strong regulation that holds individuals and entities accountable and deters misconduct promotes public confidence in financial services and is a key factor in the development of efficient markets, financial services and economies.
5. Enforcement plays an important role in deterring misconduct and thereby promotes public confidence, consumer protection and market integrity. While other regulatory activities, such as authorisation and supervision, also have a strategic function in deterring misconduct, this paper focuses primarily on those factors that are within the remit of enforcement programmes.
6. In addition to an effective sanctions regime, are other factors that can deter misconduct in a credible way, including strong and resilient regulatory governance, comprehensive enforcement powers, and good regulatory practices such as timeliness of enforcement intervention and holding individuals and entities accountable. Other factors include the use of new technologies and techniques that bold regulators can employ to deter misconduct.
7. Jurisdictions and regulators seeking to maximise deterrence within their regulatory frameworks may find some of the factors worthy of further consideration. The factors referred to in this paper are not weighted or ordered in any priority as each can contribute to deterrence in different ways. Further, the effectiveness of the factors may be influenced by the unique legal and regulatory characteristics of each jurisdiction, the political and economic framework, the specific facts, circumstances and nature of the conduct to be deterred and the social, cultural, and economic environment.
8. A successful credible deterrence strategy can modify behaviour and reduce securities law violations, which in turn increases investor protection and can thereby create an environment in which fair and efficient markets can thrive.

## The concept of deterrence

9. Deterrence in securities regulation proposes that laws are passed with well-defined punishments to discourage recidivists and others in society from engaging in misconduct.
10. An effective deterrent framework would guarantee that those who engage in misconduct will be detected, prosecuted and sanctioned, and will receive no personal benefit from their wrongdoing. However, it is unrealistic to expect that any system could ever, in absolute terms, accomplish this goal, no matter how many resources are dedicated to achieving it. Therefore, regulators need to examine workable strategies that maximise the prospects of delivering credible deterrence in a risk-based environment.
11. Deterrence is at the heart of the strategies of securities regulators whose objectives are to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. There is no one-size-fits-all approach but whatever the regulatory model (twin peaks, integrated, industry-based or functional) and approach (risk, principles or rule-based) a common implied or explicit objective of enforcement programmes is credible deterrence.
12. Deterrence can be credible if it is supported by a robust sanctions regime that acts as a catalyst to foster propriety and compliance with legislated practices and standards of behaviour.
13. In 1998, IOSCO issued its Objectives and Principles of Securities Regulation (IOSCO Principles), which set out a framework to achieve the objectives of regulation. The framework is comprised of principles to which regulators should aspire, including principles relating to enforcement and cooperation.<sup>1</sup> This paper complements the relevant IOSCO Principles by encouraging wider strategic thinking about how to achieve and maintain credible deterrence. It does not alter the Principles or the Methodology which support the assessment of compliance with the Principles.
14. Although this paper promotes deterrence in the context of enforcement, other regulatory activities such as authorisation, supervision, surveillance and compliance are important to deterrence strategies. They can be cost-effective regulatory tools because they may be less resource and time intensive than enforcement action. Moreover, they can prevent misconduct occurring before investors or the markets are harmed.
15. Authorisation is the gate keeper to the financial services industry and can therefore prevent bad players from entering the industry. Supervision and surveillance monitor the conduct of those who participate in the industry. Supervisory and surveillance activities are useful sources of information and together with compliance can be effective mechanisms for preventing misconduct and detecting, mitigating and containing the effects of misconduct after it has occurred.
16. All regulatory functions, including authorisation, supervision and enforcement, should work together to achieve deterrence in securities regulation. Proactive programmes, such as financial literacy programmes that enhance investor awareness, may be a part of a broader credible deterrence strategy but are not strictly part of the enforcement toolkit and are therefore not considered in detail in this paper.

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<sup>1</sup> *Objectives and Principles of Securities Regulation, June 2010, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf> and Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf>*

## Factors underpinning credible deterrence

17. Regulators can deter misconduct when they:

- a) **enhance the quality of legal and regulatory frameworks to provide legal certainty.** The quality of legal and regulatory frameworks and the laws that underpin them play a prominent role in shaping behaviour by creating and enforcing a system of incentives and disincentives. Legal and regulatory frameworks that provide legal certainty inspire confidence in the administration of justice and regulation and establish a platform upon which individuals and entities can organise their affairs in a manner that complies with the law, and understand that if they act in a manner that is outside the law they will be held accountable.
- b) **detect misconduct by being well connected and getting the right information.** Regulators who use mechanisms to detect misconduct in a timely way will create an environment in which those contemplating or involved in misconduct have an expectation that they will be caught. Regulators who are well connected and have access to sources of intelligence providing real time information will be more likely to detect misconduct before it causes harm to investors or markets.
- c) **co-operate and collaborate to eliminate safe havens and work together.** Potential wrongdoers may be deterred from engaging in misconduct when they know that securities regulators are working with criminal authorities and other domestic, national and international agencies to strengthen their detection, investigation, prosecution and sanctioning capabilities and when they understand they cannot hide behind borders because cross border regulatory counterparts are working together to ensure violators have no safe haven.
- d) **rigorously and swiftly investigate and prosecute<sup>2</sup> misconduct.** Potential wrongdoers may be deterred from engaging in misconduct when they realise that regulators will hold wrongdoers accountable for their actions and that they will be resolutely and swiftly investigated, prosecuted, and sanctioned. Timely enforcement interventions prevent misconduct crystallising into investor detriment and harm to market integrity.
- e) **impose sanctions that are effective, proportionate and dissuasive.** Sanctions can be a deterrent to wrongdoing and recidivism when they are consistently and reliably applied and have a meaningful correlation to the gravity of the misconduct, the economic and social impact of the misconduct, the unjust enrichment of the wrongdoer and the cost to investors. When potential wrongdoers believe the cost of engaging in misconduct is greater than the reward, they may be dissuaded from engaging in it. Regulators who have and use an array of regulatory responses and sanctions are more likely to deter potential wrongdoers' involvement in misconduct.
- f) **send strong public messages, and promote public understanding and transparency.** Public messaging and understanding of regulatory mandates strengthens deterrence by informing would-be wrongdoers that misconduct will be detected, investigated and sanctioned and that regulators are working together to enforce the law and hold individuals and entities accountable. Regulators who communicate their objectives, mandates and outcomes enhance the deterrent impact of enforcement activities. Public messages send a clear signal as to what behaviour is unacceptable and thereby help to set industry standards.

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<sup>2</sup> This paper uses the word *prosecute* to mean taking legal action against accused persons by securities regulators or other sanctioning authorities.



- g) **evaluate and revise enforcement governance, strategy, priorities and tools.** Regulators who continually evolve their enforcement strategies, by regularly reviewing their governance arrangements, prioritising and allocating resources and ensuring that enforcement tools are fit for purpose will be organisationally agile and more responsive to emerging risks. When regulation is well designed and regulators have well developed enforcement strategies, target and prioritise misconduct and have the tools to detect, rigorously investigate, prosecute and sanction wrongdoing, then the risk of engaging in misconduct will outweigh the benefit.
18. A further description of each of the seven factors, together with examples of useful powers and good enforcement practices adopted by securities regulators to deter misconduct is provided in this paper under ***Credible Deterrence Factors***.

# Credible Deterrence Factors

## Factor 1: Legal certainty: Certain and predictable consequences for misconduct

### In brief

19. Laws that are certain and predictable, and allow individuals and entities to foresee, and be held accountable for, the consequences of their actions can deter misconduct. Laws should be written, interpreted and applied in a way that fosters legal certainty, so that individuals and entities can understand the laws and rules that apply to them, foresee the consequences of their actions and organise their affairs in a way that complies with obligations.
20. Misconduct can be deterred when:
  - a) laws and regulations are clear, unambiguous and foster legal certainty;
  - b) the legal and regulatory framework is tailored to the jurisdiction;
  - c) the framework is transparent and people know and understand the obligations that apply to them;
  - d) the regulatory framework creates the expectation that the laws and regulations will be enforced and that misconduct will be detected, investigated and sanctioned;
  - e) there are appropriate avenues for the prosecution and remediation of misconduct; and
  - f) administrative and judicial decision makers are informed, impartial, independent and competent.

### In detail

#### Legal and regulatory frameworks

21. An unambiguous legal framework can create a deterrent effect by minimising incentives for wrongdoing. The design of legal and regulatory frameworks should be tailored to the needs and characteristics of each jurisdiction, including the nature, size and complexity of its markets, the financial products and services offered in the market, and the legal, economic, cultural, political and social environments.
22. A tailored framework should create the expectation that misconduct will be detected, investigated and sanctioned. It should also convey to potential wrongdoers that regulators and administrative and judicial decision makers have a varied and robust range of powers and remediation tools to effectively detect, investigate, remediate and sanction misconduct.
23. To that end, legal and regulatory frameworks should empower regulators to detect, investigate and sanction misconduct and provide appropriate avenues, including administrative, civil (including civil penalty), or criminal (including quasi-criminal), for the remediation of misconduct and the imposition of sanctions.

## EXAMPLES

Many jurisdictions have a range of avenues, including administrative, civil and criminal to prosecute and sanction misconduct. For example, the Securities and Futures Commission of Hong Kong (HK SFC) and the Australian Securities and Investments Commission (ASIC) have the power and flexibility to pursue both deterrent and remedial actions against market misconduct through a variety of routes including criminal prosecutions and administrative, disciplinary and civil proceedings.

### Explicit and effective laws

24. Laws and regulations that are unambiguous foster legal certainty and deter misconduct.
25. Whatever the regulatory design, (i.e. twin peaks, integrated, industry based or functional), the quality and effectiveness of the legal and regulatory framework can play a dominant role in strengthening regulation. Some regimes adopt a *principles or outcomes* based approach to regulation that relies on broad but well-defined principles of acceptable behaviour, e.g. the obligation to act honestly, with integrity or with due skill, care and diligence. Other regimes adopt an approach that relies more on prescriptive rules. Whatever the approach, the principles or rules that govern behaviour should be unambiguous as to what is and is not acceptable behaviour and the consequences for engaging in improper conduct. Principles and rules can be supported by regulatory guidance. Enforcement actions serve to amplify the scope and meaning of rules and principles.

### Transparency of laws and procedures

26. The value of a well-developed legal and regulatory framework and a robust enforcement programme is diminished if industry participants are unaware of it or of the consequences of non-compliance with its requirements. As a starting point and in order to play by the rules, individuals and entities should know what the rules are and the consequences of non-compliance.
27. Knowledge and understanding of the law is, of itself, a deterrent to wrongdoing for the majority of the population who are law abiding citizens. The failure to comply with obligations may sometimes arise due to insufficient awareness of the law and its application. The regulated community should know the regulatory and legal frameworks that apply to them, understand regulatory expectations of behaviour and be able to see clear and consistent regulation of obligations and tangible consequences for non-compliance with those obligations and other misconduct.
28. Transparency of laws and procedures helps develop awareness and understanding of obligations and can assist individuals and entities to comply with the laws and rules that apply to them. Transparency occurs when proposed laws and regulations are open for public consultation and when regulators publish their policies, practices and procedures. In addition, presentation of laws and regulations in plain, easy to understand language can enhance transparency. Publication of enforcement actions, with descriptions of the misconduct and the reasons for the sanction, is an important transparency mechanism.

## EXAMPLES

Many regulators publish guidance setting out their enforcement, decision making and sanctioning processes to assist those persons who may be the subject of disciplinary proceedings and others. For example, the HK SFC publishes a pamphlet titled *Disciplinary Proceedings at a Glance*, which provides a brief overview of its disciplinary processes including criteria for determining whether to take disciplinary action, the disciplinary measures available to the HK SFC and a description of the disciplinary process. The HK SFC also publishes the *Disciplinary Fining Guideline* which shows how the HK SFC will perform its functions when imposing a fine on a regulated person by setting out the factors that the HK SFC will take into account when exercising its fining power. ASIC publishes *Information Sheets on topics such as ASIC's compulsory information gathering powers and ASIC's approach to enforcement* and Regulatory Guides, such as, *Administrative action against financial services providers*.

The Federal Financial Supervisory Authority of Germany (BaFin) publishes guidelines on its fining procedures including information about deterrence, and penalty calculations.

The Comissão de Valores Mobiliários of Brazil (Brazil CVM) publishes *ofícios-circulares* (guidance letters) which are sent to all relevant regulated entities or individuals and made publicly available on the Internet. Such letters normally contain clarifications and guidance on new rules, interpretations on the application of rules, alerts and reminders of applicable sanctions, among other features.

The United States Securities and Exchange Commission (US SEC) publishes its Enforcement Manual.<sup>3</sup> The Enforcement Manual contains a wide range of policies and procedures that provide guidance to the staff of the US SEC's Division of Enforcement. The public and other regulators have full access to this guide on the SEC's website. The US SEC website also contains a wide range of information about the US SEC's enforcement outcomes such as administrative proceeding orders,<sup>4</sup> litigation releases,<sup>5</sup> and court filings.<sup>6</sup> Similarly, the UK Financial Conduct Authority (UK FCA) publishes its Enforcement Manual which explains its approach to enforcement and its Decision Procedures and Penalties Manual which explains its decision-making processes, including in respect of calculating financial penalties.

### Transparency of proceedings

29. The ability of the public and media to observe proceedings is a discrete but important aspect of the regulatory system that can deter misconduct and one that promotes transparency and confidence in the legal, regulatory and judicial systems. Many regulators, disciplinary tribunals and courts conduct proceedings in public. Such transparency promotes public understanding of the legal and regulatory frameworks that govern behaviour in financial services regulation and is another mechanism that may influence behaviour in a positive way.

3 <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>

4 <http://www.sec.gov/litigation/admin.shtml>

5 <http://www.sec.gov/litigation/litreleases.shtml>

6 See, e.g., <http://www.sec.gov/litigation/appellatebriefs.shtml>

## EXAMPLES

The Comisión Nacional del Mercado de Valores of Spain (Spanish CNMV) publishes a Jurisprudence eBook in which Court Judgments are classified by applicable legislation, judgments and chronologically.

### Judicial and administrative competence

30. The speed of legal and regulatory reform has placed increased challenges and burdens on administrative and judicial decision makers and legal and regulatory systems. Because enforcement might require the involvement of the courts and prosecution authorities, the credibility of securities regulators can depend on the efficiency of the legal and judicial system and the quality and independence of decision making. Timeliness, consistency and reliability of decisions are therefore critical features of an effective legal and regulatory framework.
31. In the complex area of securities regulation, specialised knowledge can enhance the quality of judicial and administrative decision making. Specialised courts that deal specifically with securities and financial services conduct may be one approach to enhance the capacity of decision making. To the extent possible, regulators should consider engaging with the judiciary (while respecting their independence) and other authorities to keep them abreast of legislative and policy changes. Good communication between regulators and judicial authorities including, where appropriate, training for judicial authorities regarding complex financial products can also be beneficial by fostering a judiciary that understands the complexity and significance of the regulator's work.

## EXAMPLES

Some regulators organise conferences and develop training programmes to inform representatives from judicial authorities (judges and public prosecutors) about the trends and characteristics of capital market legislation and regulation.

Several regulators liaise with the judiciary and other competent authorities to develop a cadre of judges and decision makers who specialise in securities and financial services regulatory issues and to expedite proceedings involving securities and financial services activities, whilst always being mindful to protect judicial independence. In some jurisdictions, specialist divisions have been created in superior courts to deal with securities regulation actions.

### Avoiding regulatory arbitrage

32. Enforcement regimes for securities law violations across the globe can vary widely. Reasons for this variety are the differing institutional and procedural arrangements across jurisdictions and the diverse application of sanctions and remedies generally. IOSCO has played a role in raising standards internationally by providing a forum and mechanisms for cooperation.<sup>7</sup> Cooperation raises the quality of securities regulation and enhances deterrence, and minimises opportunities for regulatory arbitrage.

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See *IOSCO Principles 10 – 15 in Objectives and Principles of Securities Regulation, June 2010* available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf> and *IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, May 2002- version revised May 2012* available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD386.pdf>

- 33.** Enforcement regimes can be most effective when they are seen to be adroit at addressing violations. Violators seek to create regulatory arbitrage opportunities by committing violations and/or seeking refuge for themselves and/or their illicit funds in jurisdictions perceived to have weak enforcement, co-operation and sanctioning regimes. Regulators should seek to remove opportunities for regulatory arbitrage by looking for ways to reform their laws and powers, raise their own standards and foster better and deeper ways of collaborating. For example, regulators may consider conducting joint investigations, increasing access to evidence for foreign authorities or other means of denying opportunities for refuge for those who engage in misconduct.

## Factor 2: Detecting misconduct: Being well connected and getting the right information

### In brief

34. By increasing the prospects of catching and punishing violators, regulators intensify the apprehension of detection and diminish the reward for wrongdoing. Detection, as a mechanism of deterrence, seeks to ensure that those who are involved in misconduct, or contemplating their involvement, have a strong expectation that the conduct will be discovered, investigated and sanctioned. Detection mechanisms can be more effective when regulators are linked in and create systems that facilitate the sharing of intelligence and information by the regulated population and the public and between regulators, both at national and international level.
35. Misconduct can be deterred when regulators:
- a) have robust market surveillance programmes and invest in technologies and resources to enhance surveillance commensurate with the nature, scale and complexity of markets;
  - b) establish mechanisms to conduct surveillance of or receive information arising from inter-exchange and cross border transactions and contracts;
  - c) co-operate and proactively share information with other international securities regulators;
  - d) develop functions to receive complaints and tips from the public;
  - e) create clear and effective pathways for examiners and other supervisory staff to report misconduct to enforcement;
  - f) oblige and influence gatekeepers to report misconduct to the appropriate authorities;
  - g) develop programmes to encourage whistleblowing to regulators;
  - h) work with self-regulatory financial industry organisations (SROs) and trade bodies to achieve timely provision of information about suspected misconduct or relevant trends in the industry.

### In detail

#### Market surveillance

36. Market surveillance is a central feature of many regulatory and enforcement programmes. Its primary aim is to detect misconduct, manipulation and other abusive practices.
37. Many regulators are now equipped with the technology, resources and competence to conduct surveillance on a real-time or near real-time basis. However, regulation of algorithmic trading and other complex trading techniques is proving challenging even for mature jurisdictions. Regulators should consider how investing in technologies and resources, commensurate with the nature, scale and complexity of the markets they regulate can enhance deterrence.

38. Regulators should consider whether their technologies are adequate for the task. For example, they could employ innovative tools including the latest market monitoring and alerting software, to detect market misconduct and take immediate action when required.

## EXAMPLES

Many regulators make use of market surveillance and cyber surveillance technologies and teams to monitor the markets and the internet for early warning signs of misconduct, so that they can intervene rapidly in the interest of investors. For example, the Québec Autorité des marchés financiers (Québec AMF) recently developed an initiative to monitor issuers who are quoted on the United States Over the Counter markets to ensure that selected issuers are not used in conjunction with a pump and dump scheme. The UK FCA utilises daily transaction data from its surveillance and monitoring system (Zen), which is combined with external data feeds, to raise alerts in respect of potential market abuse.<sup>8</sup>

The China Securities Regulatory Commission (CSRC) designed and developed a data model, based on a study of the prominent attributes of insider trading, market manipulation, front running and other market abuse violations, to identify market misconduct. This data model is used in conjunction with a public disclosure monitoring system that monitors news, peer information and other public disclosures about listed companies to generate intelligence for identifying market abuse violations.

In several jurisdictions exchanges are required to have independent trading surveillance capacities to analyse market activities in real time using customised in-house systems and are required to refer suspicious trading activities to the regulator.

The Capital Markets Board of Turkey (CMB) uses sophisticated software to collect and analyse trading data. The CMB also gets data from other governmental authorities such as the national citizenship agency. The software allows searches across family members and can show conflicts of interest.

## Cross border surveillance

39. Inter-exchange and cross border surveillance of transactions and contracts is an increasingly important regulatory function. Regulators with access to multiple streams of information from domestic and foreign exchanges can enhance deterrence. Regulators should consider exploring ways to receive trading data from multiple exchanges and foreign regulators. They should also consider the benefits of collaborating and sharing intelligence derived from surveillance and other activities as a means of detecting and deterring misconduct. Regulators could also consider establishing arrangements for obtaining information from Financial Intelligence Units (FIUs) to supplement intelligence about transaction flows.

## EXAMPLES

The European Securities and Markets Authority (ESMA) has installed a Transaction Reporting Exchange Mechanism, used by European securities regulators to exchange data on securities transactions.

<sup>8</sup> <http://www.fca.org.uk/firms/systems-reporting/transaction-reporting/zen>



## Reporting mechanisms for the public

40. The public can be a useful source of information and intelligence to identify misconduct. Deterrence can be enhanced when regulators have transparent, well known and easily accessible mechanisms for the public to provide tips and make complaints about suspected or actual misconduct.
41. A centralised, well-resourced and competent tipping or complaints management function can provide valuable intelligence to regulators to identify misconduct and risks and vulnerabilities to investors and the financial system. The public will be emboldened to make complaints and provide tips if they have confidence in the integrity and responsiveness of the complaints and tips functions.

## EXAMPLES

Most regulators have electronic platforms for making and receiving complaints and tips from the public. For example, the Financial Market Authority of New Zealand (NZ FMA) provides an anonymous complaints portal on its website. The portal offers strong anonymity and does not record or retain the ISP addresses of informants. The Turkey CMB complaints system offers the option for complainants to disclose their identity or remain anonymous.

The UK FCA runs customer and consumer contact centres to provide information and guidance to both firms and consumers who contact the UK FCA. Additionally, the UK FCA has a department dedicated to capturing intelligence about the consumer perspective, developing insights into the consumer experience and converting it into risk awareness for the wider UK FCA. This includes engaging with consumers, for example through research and consumer representatives, and ensuring that the UK FCA is engaged with consumer concerns.<sup>9</sup>

## Intra-agency information flows

42. The flow of information within a regulatory agency is as critical as the flow of information between regulatory and enforcement agencies. Specialist divisions, including supervision and surveillance programmes, frequently identify misconduct at an early stage. Deterrence can be enhanced when regulators provide pathways for examiners and other supervisory staff to report misconduct to enforcement. The timely flow of information from supervisory and surveillance programmes to enforcement can enable regulators to intervene and deter misconduct before it becomes widespread.

## Gatekeepers

43. Jurisdictions can enhance deterrence by giving regulators ways to acquire information from gatekeepers, such as through compulsory reporting requirements enshrined in legislation. Compliance officers, trustees, auditors, credit rating agencies, issuers and their managers/directors, sponsors and professional advisers are important sources of information. Regulatory obligations placed on those persons and entities to make disclosures about any activity that might constitute a contravention of laws, regulations or policies can serve to promote deterrence. Regulators can consider ways to enhance the quality and timelines of reporting, e.g. by holding gatekeepers accountable for their acts and omissions.

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9 <http://www.fca.org.uk/site-info/contact>

## EXAMPLES

In many jurisdictions regulated entities are routinely required to provide Suspicious Transaction Reports to the regulator in the event the entity becomes aware of circumstances that might constitute a suspicious transaction that contravenes anti-money laundering laws, or which might constitute informed trading ahead of an announcement.

Many jurisdictions require licensed entities, their auditors, company receivers and liquidators to disclose, to the regulator, any information which might show an illegal act, or a failure to comply with legal obligations by a regulated person or its officers or a public company and its officers.

In South Korea, each financial institution and electronic financial business operator is required to report to the Financial Services Commission (SK FSC) and the Governor of the Financial Supervisory Service (SK FSS) any IT incidents that result in, for example, suspensions or delays in IT services to consumers or markets caused by cyber-attacks, manipulation of computer data, hacking or systems failure.

The US SEC's *Operation Broken Gate* focuses on holding accountable gatekeepers who fail to carry out their duties and responsibilities in a manner consistent with professional standards. Under this initiative, auditors, attorneys and other gatekeepers, who have special duties and responsibilities to safeguard the interests of investors, have been held accountable.

## Whistleblowers

44. Whistleblowers are a useful source of information and intelligence. Reporting can be enhanced when jurisdictions provide legal protection to whistleblowers to prevent them from being adversely impacted or prejudiced as a result of providing information.

## EXAMPLES

The US SEC and the US Commodity Futures Trading Commission (US CFTC) are authorised to reward eligible individuals who come forward with high-quality original information that leads to an enforcement action in which over \$1 million in sanctions is ordered. The range for awards is between 10% and 30% of the money collected.<sup>10</sup> The US SEC and US CFTC have each established an Office of the Whistleblower to administer their respective programmes.<sup>11</sup>

European Union (EU) Regulation No 596/2014 introduces a framework for whistleblowers in the Market Abuse regime applicable in the European Economic Area so that adequate arrangements are in place to enable whistleblowers to alert competent authorities in EU Member States to possible infringements of market abuse regulations and to protect them from retaliation. The regulation allows Member States to provide financial incentives for those persons who offer relevant information about potential infringements of market abuse regulations.

<sup>10</sup> Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act available at <https://www.sec.gov/mwg-internal/de5fs23hu73ds/progress?id=JAaK1jCrW> mandated that the US SEC establish a Whistleblower programme to make significant monetary rewards to eligible individuals who voluntarily provide original information that leads to successful Commission enforcement actions.

<sup>11</sup> See <http://www.sec.gov/whistleblower> and <http://www.cftc.gov/ConsumerProtection/WhistleblowerProgram/index.htm>

A number of jurisdictions have legislation that affords confidentiality and legal protection to whistleblowers that make it unlawful for action to be taken by their employers for their whistleblowing. For example, the New Zealand Protected Disclosures Act provides protection to employees who make complaints to authorities. Confidentiality is also afforded to informants through other legislation including the Evidence Act and Securities Act. In 2012, the New Zealand courts recognised the importance of informants and, on the NZ FMA's application, prevented the disclosure of a whistleblower's statement and the identity of an informant in a Securities Act investigation.

### Targeted programmes

45. The unique characteristics of each market, including its type, size and maturity, will determine the characteristics of surveillance programmes necessary to detect and interrupt misconduct. For example, financial reporting and audit programmes are a common feature of most mature and some emerging jurisdictions.
46. Commodity, equity, financial and other specialised markets require specialised surveillance skills and technologies. To the extent possible, regulators should consider dedicating resources to cutting edge tools and infrastructure to help them fulfil their mandates.

### EXAMPLES

The US SEC launched the Center for Risk and Quantitative Analytics, which helps it develop technologies to analyse trading and other types of data available from a wide variety of venues.<sup>12</sup>

### Self-regulatory and industry supervisory groups

47. A feature of securities enforcement, particularly in mature jurisdictions, is the widespread use of SROs to monitor parts of the financial services industry. SROs play an increasingly important role in guiding the behaviour of industry participants. Deterrence arising from enforcement activities is supported when SROs and other industry organisations collaborate with the regulator. Conversely, an SRO without robust and committed regulatory infrastructure can undermine a regulator's efforts to promote credible deterrence. Regulators should consider having regular dialogue with SROs, and/or inspections of SROs, to ensure they fulfil their regulatory mandates and provide information, on a timely basis, about suspected misconduct. Regulators could also encourage SROs to strengthen their governance and the quality of their compliance and risk management arrangements in ways that would enhance deterrence.
48. Securities laws and regulations that require regulated entities to monitor compliance within their own institutions can be an important force for deterrence. Regulated entities are likely to be well-placed to know where risks exist for their employees and/or clients to engage in misconduct. Laws and rules that require entities to construct and monitor controls

<sup>12</sup> SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis, Securities And Exchange Commission, 2 July 2013, available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171624975>

systems can be strong deterrents to misconduct. Moreover, holding managers accountable for the proper functioning of compliance systems can bolster a regulator's ability to send the message that violations will be detected. If supervisors can be sanctioned for their employee's violations, one can assume that those supervisors will be strongly motivated to deter such violations.

## EXAMPLES

The Securities and Exchange Surveillance Commission of Japan (Japan SESC) has been working with SROs, such as securities exchanges and the Japan Securities Dealers Association, to ensure that the SROs are actively taking steps to prevent fraudsters from entering the markets.

German securities exchanges are self-regulatory in that they are required to have independent trading surveillance offices that work together closely with and send reports directly to BaFin's securities monitoring department.

The US SEC works with SROs, such as the Financial Industry Regulatory Authority, (FINRA) which has developed a programme called the Securities Observation, News, Analysis and Regulation system that flags unusual price and volume movements in traded securities and identifies potential insider trading and fraud against investors.<sup>13</sup>

A Memorandum of Understanding between the US SEC and the Financial Crimes Enforcement Network (FinCEN), the financial intelligence unit in the United States, provides FinCEN with detailed information on a quarterly basis regarding the anti-money laundering and enforcement activities of the US SEC and SROs. In turn, under the agreement, FinCEN provides assistance and analytical reports to the US SEC.<sup>14</sup>

US securities laws authorise the US SEC to sanction brokers and dealers that fail reasonably to supervise persons associated with regulated entities who commit violations of the US securities laws.<sup>15</sup>

The US SEC has developed under its Quantitative Analytics Unit a National Exam Analytics Tool (NEAT). With NEAT, US SEC examiners are able to access and systematically analyse extremely large amounts of trading data from entities in a fraction of the time than it had taken in the past.<sup>16</sup>

13 See *FINRA Retooling Market Surveillance to Catch Abuses*, Bloomberg News, 18 December 2010 available at <http://www.bloomberg.com/news/2010-12-17/finra-plans-to-improve-surveillance-to-catch-insider-trading.html>

14 *SEC and FinCEN Sign Information Sharing Agreement*, 21 December 2006, available at [http://www.fincen.gov/news\\_room/nr/html/20061221.html](http://www.fincen.gov/news_room/nr/html/20061221.html)

15 See Section 15(b)(4)(E) of the Securities Exchange Act of 1934 available at <https://www.sec.gov/mwg-internal/de5fs23hu73ds/progress?id=nFPGI/cKdM>

16 *Chair Mary Jo White, The SEC in 2014*, 27 January 2014, available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540677500>

## Factor 3: Co-operation and collaboration: Eliminating safe havens by working together

### In brief

49. The awareness that securities regulators are working with criminal authorities and other domestic and international agencies to share information (both public and non-public) and strengthen their detection, investigation, prosecution, and sanctioning capabilities in response to wrongdoing, can help to deter individuals and entities from engaging in misconduct. When potential wrongdoers learn that they cannot hide behind borders because regulators and enforcement agencies are working together to remove safe havens, disgorge the proceeds of unlawful activity and prosecute offenders then the incentives for misconduct can be reduced. Domestic and international co-operation arrangements, such as the IOSCO Multilateral Memorandum of Understanding (MMoU),<sup>17</sup> when used to their fullest capacities to aid investigation, litigation and prosecution can dissuade a would-be violator from engaging in misconduct because of the knowledge that attempting to hide evidence, money or his or her person in a foreign jurisdiction is not likely to succeed.
50. Misconduct can be deterred when regulators:
- a) co-operate and collaborate with domestic and international industry bodies, SROs, other regulators, enforcement and prosecution authorities, administrative, civil, criminal judicial decision makers (where permitted and as appropriate) and governments to enhance the effectiveness of enforcement and to fulfil regulatory mandates;
  - b) take the necessary measures to satisfy the preconditions for signing the IOSCO MMoU, including the removal of legal obstacles for the sharing of information, co-operation and collaboration;
  - c) not prohibit or place unreasonably restrictive conditions on co-operative or collaborative efforts;
  - d) make efforts to promote their government's ratification and implementation of international conventions, treaties and agreements that enhance the effectiveness of domestic enforcement programmes;
  - e) consider other formal channels for the sharing of information such as the traditional gateway embodied in a treaty for mutual legal assistance and agreements of mutual understanding;
  - f) share information about misconduct and emerging and existing enforcement risks;
  - g) have a centralised and efficient process for the timely prioritisation and execution of information requests from other regulators; and
  - h) participate in domestic and international fora to enhance the capacity and effectiveness of enforcement.

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17 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD386.pdf>

## In detail

51. Bilateral and multilateral approaches to enforcement are engendering enforcement outcomes that could not have been achieved through unilateral action alone. Collaborative enforcement efforts are now adopted to fight global misconduct. Individuals and institutions engaging in misconduct across multiple jurisdictions are increasingly scrutinised and held accountable by coordinated investigatory and enforcement efforts.
52. Regulators should consider all legal opportunities to help ensure effective domestic and global cooperation and collaboration and to preserve and strengthen securities markets domestically and around the globe. They should encourage the development of, and have access to, useful enforcement tools at both the domestic and global levels. These tools should provide a legal basis for the exchange of information, and the sharing of intelligence on emerging and existing risks, and also, where authorised, facilitate the exercise of enforcement powers (such as conducting compulsory interviews or securing freezing orders) in the event of cross border misconduct. In addition, informal networks among regulators are helpful, particularly for the early identification of and a quick response to issues.

## International

53. Conducting cross border investigations is a challenging endeavour made even more difficult by the legal and cultural differences between jurisdictions.
54. International arrangements, such as the IOSCO MMoU, are a catalyst to dissuade potential wrongdoers from committing unlawful activity because they facilitate information sharing and co-operation that may ultimately lead to the detection and prosecution of illegal conduct and the disgorgement of illicit profits.
55. Although there is presently strong co-operation between many securities regulators, especially as facilitated by the IOSCO MMoU, all jurisdictions can look for additional ways to improve cooperation, and consequently deterrence. For instance, regulators should consider reducing restrictions on their ability to share information with domestic and foreign counterparts. IOSCO has addressed these impediments by encouraging those securities regulators who are not signatories to the MMoU to amend their legal frameworks and become signatories. IOSCO has also urged regulators to commit to the spirit and letter of the IOSCO Principles and to the collaborative arrangements espoused in the MMoU, which is based on the concept of providing the fullest assistance permissible.

## EXAMPLES

Many securities regulators now have specialised international units that are charged with liaising with foreign authorities, both civil and criminal, and that handle incoming and outgoing enforcement-related requests, such as those made under the IOSCO MMoU.

56. In addition to becoming signatories to the IOSCO MMoU, jurisdictions should consider how deterrence may be enhanced by becoming a party to, ratifying and implementing international conventions, treaties, understandings and agreements that enhance the effectiveness of enforcement programmes and facilitate regulatory co-operation. Regulators should consider consulting with relevant authorities who have the power to enter such conventions, treaties, understandings and agreements for mutual assistance which provide a legal basis for transmitting evidence between jurisdictions for use in prosecution and

judicial proceedings, entering arrangements with FIUs to trace and track transactions and the proceeds of crime and, as needed, bilateral agreements of mutual understanding between jurisdictions.

57. Some jurisdictions have the power to prosecute civil and/or criminal offences such as insider dealing; however the powerful deterrent effect of potential criminal prosecution can be undermined if suspects are able to simply leave the jurisdiction so as to avoid sanctions and/or arrest. International cooperation is essential in order to bring the suspects to justice.
58. Jurisdictions in which securities regulators have a role in extraditing individuals, and restraining, freezing and repatriating assets, will want to explore how they can avoid providing safe havens for assets and for individuals who face the prospect of legal proceedings or being charged with securities and financial services violations. This is likely to involve liaison with FIUs and criminal authorities. Areas for consideration include arrangements that provide information about individuals, their accounts, investments and assets that can be readily shared with domestic and foreign authorities.
59. Jurisdictions should consider whether:
  - a) there is an adequate legal framework for the extradition of individuals and for the restraint, freezing and repatriation of assets;
  - b) securities and financial services law violations should be extraditable offences;
  - c) there are transparent and efficient processes for responding to extradition requests, restraining conduct, and when applicable, restraining, freezing and repatriating assets; and
  - d) conditions for the timely completion of extradition, the restraining of conduct, and the freezing and repatriation of assets requests are unduly restrictive.

## EXAMPLES

Both ASIC and the UK Financial Services Authority (the UK FCA's predecessor) have been successful in the extradition, conviction and incarceration of individuals on criminal charges.

The European Arrest Warrant (EAW) replaces extradition arrangements between individual EU member states. Under the rules of the EAW, an EU member state cannot refuse to surrender its citizen to another EU member state where that citizen has committed, or is suspected of having committed, a serious crime (including, for example, fraud and money laundering).

60. In addition to the cooperation arrangements under the MMoU, regulators should consider having internal protocols for collaborating with other regulatory agencies. The IOSCO Joint and Parallel Investigations Guide<sup>18</sup> is a helpful template. The protocols may particularise the practical procedures for collaboration on cross border investigations, e.g. establishing regulatory colleges to consider, where appropriate, enforcement objectives, information

<sup>18</sup> Non-public Report of IOSCO Committee 4 for Enforcement and the Exchange of Information, (IOSCO member's only webpage).

sharing, actions, timescales, prosecutions and settlements. When embarking on a joint or parallel investigation, regulators could consider arrangements that address the extra-territorial impact of domestic enforcement, regulatory and legislative developments on other jurisdictions. For instance, a prosecution of misconduct in one jurisdiction may raise constitutional and/or legal issues, such as double jeopardy, in another. Or the compulsion of testimony in one jurisdiction may affect the use that may be made of that testimony in another jurisdiction.

61. Regulators should also strive for cooperation and collaboration in the broader regulatory community. They should share know-how and inform relevant domestic and international stakeholders, including legislators and international standard-setting bodies, such as IOSCO, of emerging and existing securities related risks and provide informed advice and feedback as to whether national and international approaches to the enforcement of securities law adequately mitigate the risks and whether the collective response is beneficial, feasible, timely and effective.

## EXAMPLES

The Ontario Securities Commission (OSC), like some of its Canadian counterparts, has the ability to freeze assets, on an *ex parte* basis, on behalf of another regulator.

The Dubai Financial Services Authority (DFSA) has used its executive powers to freeze assets<sup>19</sup> on behalf of another regulator<sup>20</sup> after the DFSA informed that regulator that assets had entered its jurisdiction which were suspected of being the proceeds of a Ponzi scheme in that jurisdiction.

The members of IOSCO's Committee 4 on Enforcement and the Exchange of Information regularly share information on significant cases, innovative investigation and enforcement practices and emerging risks to investors.

European securities regulators that are members of ESMA's Market Integrity Standing Committee regularly exchange views on the application of European and national market integrity laws in the respective states.

## Domestic

62. Much of the work of IOSCO focuses on international collaboration, co-operation and networking between regulators. However regulators should consider how well developed and effective domestic co-operation arrangements can enhance deterrence. Effective collaboration between regulatory, enforcement, prosecutorial and other authorities can lead to better enforcement outcomes that are likely to deter misconduct in the future. Such co-operation could include:

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19 Article 76 - Restriction on Dealing with Property of the Regulatory Law, DIFC Law No 1 of 2004., , available at [http://dfsa.complinet.com/net\\_file\\_store/new\\_rulebooks/d/f/DFSA1547\\_7446\\_VER170.pdf](http://dfsa.complinet.com/net_file_store/new_rulebooks/d/f/DFSA1547_7446_VER170.pdf)

20 Article 39 - Exercise of Powers on behalf of other Regulators, of the Regulatory Law, DIFC Law No 1, of 2004 available at [http://dfsa.complinet.com/net\\_file\\_store/new\\_rulebooks/d/f/DFSA1547\\_7446\\_VER170.pdf](http://dfsa.complinet.com/net_file_store/new_rulebooks/d/f/DFSA1547_7446_VER170.pdf)



- a) bilateral and/or multilateral arrangements that provide direct and timely information, assistance, co-ordination and collaboration between regulators, financial intelligence units, the police, prosecution and other appropriate authorities and government agencies;
- b) arrangements to develop the capabilities of relevant authorities to deal with the complexity of enforcement and regulation generally; and
- c) appropriate collaboration with industry and SROs to anticipate and deal with breaches of industry and regulatory standards.

## EXAMPLES

Several jurisdictions have co-operation agreements between regulators and other enforcement agencies under which intelligence and resources are shared. For example, the US CFTC has entered into a Memorandum of Understanding (MoU) to second US Federal Bureau of Investigation (FBI) Special Agents and Intelligence Analysts from the FBI's Economic Crimes Unit into the US CFTC to facilitate cooperation and improve the process for referring information between the two agencies to combat securities fraud and market manipulation. The US SEC also entered into an MoU with the FBI to embed FBI agents within the US SEC's Office of Market Intelligence.

The Brazilian CVM has co-operation agreements with other enforcement agencies under which intelligence and resources are shared. For example, the CVM has entered into MoUs with the Federal Police and the Federal Prosecutor's Office in order to enable higher agility and effectiveness in prevention, diligence and suppression of harmful practices in the securities market. This objective has been achieved through: (i) exchange of information, documents and technical papers related to securities market regulation and supervision; (ii) technical and scientific cooperation through studies and research and; (iii) appropriate legal measures to defend securities market interests and its respective investors.

The Comisión Nacional Bancaria y de Valores of Mexico (Mexican CNBV) has the power to coordinate with other local financial authorities (i.e. Banking and Insurance Commission, Pension Funds Commission, Protection of the Users of Financial Services, Central Bank, and Federal Deposit Insurance Institute) joint inspection visits, without prejudice to independent investigation inspections by the individual financial authorities. Moreover, when any local financial authority detects a potential violation with an entity under the supervision of another authority (e.g. the CNBV), it will give immediate notice to the other authority, so potential or actual wrongdoing may be detected in a timely manner and enforcement actions can be triggered immediately on a joint or individual agency basis.

The SK FSC and the SK FSS have measures to detect cyber-attacks through the Electronic Financial Emergency System and have acted swiftly in response to cyber threats by running cyber-attack countermeasure systems at banks and at the Korea Financial Telecommunications and Clearing Institute (KFTC) to minimize any potential damage. An Emergency Countermeasure Task Force has been formed between the SK FSC/SK FSS, and the KFTC to closely monitor any suspicious activities or signs of further attacks. Banks and financial companies are alerted to such attacks and are directed to run 24-hour emergency monitoring surveillance.

In 2013, the SK FSC and the SK FSS jointly formed an emergency response team to respond to cyber-attack threats against financial institutions. The SK FSS dispatched inspection teams to affected banks to investigate the cause of incidents and restore operations. The SK FSC worked in cooperation with the Information Share Analysis Centre (ISAC), the KFTC and Koscom to

uncover details of all incident. The Korean Internet Security Agency (KISA) distributed vaccine programmes against malicious codes and temporarily shut down servers for vaccine updates in case of additional attacks. The SK FSC and SK FSS directed banks to develop and implement measures to compensate customers for any losses or damage, if any, resulting from cyber-attacks.

The Securities and Exchange Board of India (SEBI) and the Financial Intelligence Unit-India, the national agency responsible for information relating to suspect financial transactions, have entered into a MoU which will enable them to cooperate in areas of mutual interest including sharing intelligence and information available in their respective databases, upgrading AML/CFT skills in the reporting entities regulated by SEBI, assessing AML/CFT risks and vulnerabilities in the capital market sector, supervising and monitoring the compliance of reporting entities with their obligations.

### Regulatory affiliations

**63.** The credibility of enforcement may depend on external parties such as the police, prosecutorial authorities and the courts. The quality of decisions and the need to act impartially, objectively, judiciously and expeditiously are critical features of an effective legal and regulatory framework that deters misconduct.

### EXAMPLES

The Québec AMF, like some of its sister regulators in Canada, maintains a constant and constructive dialogue with policy, administrative and judicial decision makers. In order to promote efficiency and effectiveness within the judicial system, it participates in a liaison committee with other prosecutorial authorities in Québec and the judiciary. This forum allows the Québec AMF to explain the issues surrounding its cases (complexity, administration of evidence) to the judiciary and to explore solutions.

The US SEC and the US CFTC work in close coordination with the Securities and Commodities Fraud Task Force, a unit under the Criminal Division of the US Department of Justice. The Task Force seeks to uncover fraud by investigating and prosecuting crimes relating to the operation of the securities and commodities markets in the United States, including all varieties of securities fraud, such as insider trading, market manipulation, accounting and regulatory reporting frauds.<sup>21</sup>

BaFin regularly participates in on-site inspections by the public prosecutors in market manipulation and insider dealing cases and assists police and prosecutors in evaluating evidence and thereby contributes specialised knowledge.

Other regulators also have arrangements whereby they liaise with the police and prosecutors whether at a case level or at a policy or strategic level.

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<sup>21</sup> *Securities and Commodities Fraud Task Force, The United States Attorney's Office, Southern District of New York, US Department Of Justice, available at <http://www.justice.gov/usao/nys/criminal.html>*

## Factor 4: Investigation and prosecution of misconduct: Bold and resolute enforcement

### In brief

64. Commitment by a regulator to the early investigation, prosecution of misconduct and the flexible use of enforcement programmes that consider and adopt a range of strategies, investigative tools and prosecutorial remedies, help to foster a regulatory environment in which misconduct is deterred.
65. Misconduct may be deterred when regulators:
  - a) are committed to the investigation and prosecution of violations;
  - b) deliver enforcement outcomes in a timely manner;
  - c) are invested with a variety of supervisory and enforcement powers, including compulsory powers to obtain assistance from registered and non-registered entities, and powers, either by executive action of the regulator or by application to a court, to sanction misconduct; and
  - d) have the authority and discretion to access a variety of enforcement avenues including civil and criminal (including quasi-criminal) tribunals and courts settlement mechanisms and voluntary but enforceable agreements, where appropriate.

### In detail

#### Regulatory resolve

66. Credible enforcement requires a strong commitment to investigate and sanction misconduct, and this includes having both robust powers and a dedication to utilising them. Regulatory resolve may be demonstrated by regulators and regulatory decision-makers who are adequately resourced, who are empowered with the authority, flexibility and discretion to initiate investigation, litigation and prosecutorial action; who have the willingness and ability to impose a range of pecuniary and non-pecuniary sanctions and remedies; and who possess the necessary skills, experience and determination to exercise these powers competently to fulfil regulatory mandates and objectives. Enforcement programmes further demonstrate credibility when they are independent and have legal protections for acts undertaken in good faith.
67. Enforcement has greater relevance and impact if enforcement interventions and outcomes are delivered in a timely manner. Enforcement programmes that have efficient and effective decision making capacities, and practices and processes that allow for timely interventions, before detriment has crystallised or to stop detrimental conduct, are important instruments for deterring misconduct. Regulators may want to review investigative practices and decision making processes where impediments to timely and effective enforcement interventions are identified.
68. If legal and regulatory obstacles to timeliness exist, jurisdictions should consider whether legislative or regulatory reforms are appropriate to ensure enforcement cases, in the first instance, and on appeal, are dealt with expeditiously.

69. In order to foster timeliness, regulators should be armed with appropriate resources and tools to detect misconduct when it occurs, and to impede its proliferation or the crystallization of risk through early intervention strategies. Regulators should be empowered to quickly intervene, prosecute and sanction the misconduct in a timely manner.
70. Enforcement outcomes have greater relevance and impact on offenders and victims if they are delivered as soon as possible after the misconduct has occurred. Likewise it is unfair for an accused to be deprived of the right to be heard expeditiously. Regulators should therefore act to expedite enforcement actions so that justice is administered in a timely manner.
71. Encouraging co-operation with investigations may enhance timeliness and leverage a regulator's effectiveness by enabling the efficient use of regulatory resources. Compliance officers and similar staff at authorised firms are uniquely positioned to assist regulators in early detection of violations and may encourage credible deterrence generally. Strategies that incentivise co-operation with regulators and other enforcement authorities (both domestically and internationally) by promoting compliance and reporting misconduct, and include programmes that encourage proactive reporting by whistleblowers, can bolster the regulator's efforts towards deterrence by allowing scarce resources to be redirected to other strategies and tools.
72. One method of reducing the time and challenges in bringing criminal proceedings before the courts is for the regulator to be granted statutory powers to prosecute offences in appropriate circumstances, e.g. market abuse and criminal financial services misconduct cases. Such an approach also reduces the lead time between the conclusion of the investigation and the bringing of charges. However it is noted that this approach can conflict with the notion that the separation of the investigator and the prosecutor is desirable to ensure objectivity in criminal prosecutions. Another approach is for there to be close cooperation between regulators and criminal authorities, which can also lead to timely and effective criminal prosecutions.

## EXAMPLES

The UK's Financial Services Authority, now the Financial Conduct Authority (UK FCA), was granted statutory prosecutorial powers under the Financial Services and Markets Act 2000, and is the main prosecuting authority for insider dealing and unauthorised financial services in the UK, working closely with the police and prosecuting authorities in criminal investigations.

Many jurisdictions have specialised administrative tribunals with judges specifically trained in securities laws. The administrative process often can be quicker and more efficient than litigating or prosecuting in court.

In many jurisdictions securities regulators work closely with law enforcement authorities and prosecutors to bring cases before courts of criminal jurisdiction.

Many regulators provide incentives to settle investigations early by offering favourable settlement terms enabling those regulators to resolve investigations more quickly. Settlement discussions may take place at any time during the enforcement process if both parties agree. Early settlement has the advantage of securing robust outcomes in an efficient way and getting the key deterrent messages out to the market, investors and consumers in a timely manner.

## Comprehensive powers

73. In general, the greater the diversity and flexibility of supervisory and enforcement powers and remedial tools, the more effective regulators can be. This includes powers that provide regulators and regulatory and judicial decision makers with the authority, flexibility and discretion to take timely action and to impose a range of pecuniary and non-pecuniary sanctions and remedies.
74. Powers that may enhance regulatory responsiveness include executive powers to:
- a) ban and suspend individuals;
  - b) prevent the issue of documents for the purpose of capital raising;
  - c) impose prohibitions and restrictions on businesses, e.g. from entering into certain types of transactions or carrying on business in a specified manner;
  - d) issue directions for prudential purposes, e.g. apply a specific provisioning or treatment for specified assets; or
  - e) provide a report, prepared by an independent or skilled person, e.g. on the adequacy and performance of systems and controls.
75. Regulatory responsiveness can also be enhanced when regulators have access to administrative and judicial decision makers who, during the course of investigations, are empowered to make urgent and interim orders, inter alia, to:
- a) prevent the destruction of evidence;
  - b) freeze assets;
  - c) require persons and entities to cease and desist or be enjoined from certain behaviour;
  - d) require a person to do an act or thing such as provide a full account; or
  - e) prohibit a person from carrying on business in a certain way.
76. There are additional powers that may enhance a regulator's ability to facilitate credible deterrence, including:
- a) compulsory powers to obtain information from non-registered persons/entities, such as books and records and testimony;
  - b) more expansive compulsory powers applicable to registered persons/entities, including compulsory inspections and seizure of information and documents, the ability to direct registrants to provide specific assistance to the regulator, such as requiring the registrant to undertake an independent review or analysis, to prepare and provide reports of independent reviews, or to otherwise act or refrain from acting in a particular manner;
  - c) the power to enjoin and sanction non-compliance with any requirements imposed by the regulator, to order remedial action, or to suspend or revoke a licence or authorisation;

- d) preventative powers to seek remedies such as industry, penny stock, officer and director bars, and bars to practice before the regulator; and
- e) sanctioning powers, either by administrative action of the regulator or by application to a court, such as orders for remedial actions, sanctions or censures, disgorgement, restitution, asset freezes and appointment of liquidators or administrators.

## EXAMPLES

Subsection 127(1) of Ontario's Securities Act gives the OSC the power to make various orders if, in the opinion of the OSC, it is in the public interest to do so. The Supreme Court of Canada has confirmed that the OSC has a *wide discretion to intervene in activities related to the Ontario capital markets when it is in the public interest to do so*. It is left to the OSC to *determine whether and how to intervene in a particular case*. While the power is broad, it is not unlimited. The OSC's jurisdiction under subsection 127(1) is neither remedial nor punitive. Rather, the OSC's authority is prospective in operation and preventative in nature.

Many regulators have the power to appoint administrators, i.e. receivers, managers and liquidators to institutions that find themselves in financial distress. Some jurisdictions are implementing resolution frameworks, such as *living wills* to accommodate financial failures in systemically important financial institutions.

The DFSA has the authority to enter the business premises (without warrant) of any person if that person may be able to give information or produce a document relevant to an investigation.

Many regulators have the authority to seek telecommunications records and data. For example, the UK FCA is one of a number of agencies in the UK which is authorised under the Regulation of Investigatory Powers Act 2000 to obtain communications data such as telephone and internet records from Communication Service Providers and to conduct directed surveillance if the agency can show that the use of those powers is necessary and proportionate and is in the context of a criminal or a UK market abuse enquiry or investigation.

The US CFTC requires, subject to certain limitations, futures commission merchants, retail foreign exchange dealers, introducing brokers, and members of designated contract markets or swap execution facilities to maintain all oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading and prices that lead to the execution of a transaction in a security, commodity interest and related cash or forward transactions, including those communicated by telephone, voicemail, instant messaging, chat rooms, electronic mail, mobile device, or other digital or electronic media, and these recordings must be retained and produced under the registrants' regular record-keeping obligations.<sup>23</sup>

In some jurisdictions, where the regulator discovers a person has contravened relevant rules, it has the power to suspend that person's permission to conduct investment business for such period as it considers appropriate. In a recent case, the UK FCA used this power to impose a ban on investment advisory firms from recruiting new advisers for a period of four and a half months until such time the advisers were adequately supervised and controlled to minimise the risk of mis-selling to consumers.

<sup>23</sup> CFTC Regulations 1.31 and 1.35, 17 C.F.R. 1.31 and 1.35 available at [http://www.ecfr.gov/cgi-bin/text-idx?SID=1702610a9f7694364eb-f472bd2da7881&tpl=/ecfrbrowse/Title17/17cfr1\\_main\\_02.tpl](http://www.ecfr.gov/cgi-bin/text-idx?SID=1702610a9f7694364eb-f472bd2da7881&tpl=/ecfrbrowse/Title17/17cfr1_main_02.tpl)

Swiss FINMA may appoint, by way of an order, an independent and suitably-qualified person, (an investigating agent) to conduct investigations of regulated persons, and implement regulatory measures that it has ordered. The regulated person or entity must allow the investigating agent access to its premises and provide him or her with all the information and documents that the investigating agent requires to fulfil his or her duties. The costs of the investigating agent are borne by the person or entity under investigation. The person or entity must, if so instructed by FINMA, make an advance payment to cover costs.<sup>24</sup> The appointment of investigating agents has proved an efficient and flexible measure to investigate complex circumstances, where FINMA has an initial suspicion that rules governing financial market regulation have been violated. FINMA uses the instrument of the investigating agent most often to investigate and liquidate entities that provide financial services without having the necessary licence and/or requirements.

### Avenues for enforcement

77. Deterrence can be enhanced when a regulator has the authority and discretion to access diverse avenues for enforcement, including administrative, civil (including civil cases that permit the imposition of a penalty) and criminal (including quasi-criminal) tribunals and courts and early resolution and settlement mechanisms where appropriate. Regulators should consider prioritising those avenues that deliver the most efficient and effective sanctions and remedies.
78. Regulators and administrative and judicial decision makers should be empowered with a suite of sanctioning powers and remedies that best address a wide range of misconduct and the national and global impact of misconduct. Credible deterrence can be achieved if regulators and other decision makers have available to them a range of different types of sanctions which either they can impose or seek to be imposed.

### EXAMPLES

Many regulators have the authority to seek relief through the civil courts both on their own action and on behalf of investors or consumers, including for the recovery of loss and compensation.

Canadian regulators may initiate quasi-criminal prosecutions for any type of offence covered by securities regulation. For example, a Canadian securities regulator recently enacted a new statutory *fraud on the market* offence, which can be prosecuted by way of quasi-criminal proceedings. Such offences allow Canadian regulators to seek severe sanctions and prison terms when criminal proceedings are unnecessary or inappropriate given the circumstances of the case.

<sup>24</sup> Art. 36 of the Swiss Financial Market Supervision Act (FINMASA). For an unofficial English translation of the FINMASA, see <http://www.admin.ch/ch/e/rs/9/956.1.en.pdf>

In a number of jurisdictions, regulators can bring a case before an administrative tribunal or a civil or criminal judicial authority. Often, when the misconduct warrants it or as necessary to obtain sufficient relief, the regulator will bring proceedings before more than one authority. The judicial authorities can impose a range of orders that may include pecuniary and non-pecuniary sanctions, injunctions and civil monetary penalties for the disgorgement of illegal profits or for losses avoided. Administrative sanctions may include cease-and-desist orders, suspension of broker-dealer and investment advisor registrations, bars, such as industry, penny stock, officer and director bars, and bars to practice before the regulator, as well as civil monetary penalties, disgorgement and undertakings.

Some regulators are empowered to commence civil proceedings and criminal prosecutions and to take *step* in action on behalf of investors and other third parties, for what might otherwise be private actions against financial markets participants. This enables regulators to address both conduct and compensation recovery issues for investors. Some jurisdictions require public interest grounds for taking action.

- 79.** Some IOSCO member jurisdictions have found that special purpose administrative structures and tribunals, administered by regulators, are efficient and effective mechanisms and avenues for sanctioning securities violations.

#### EXAMPLES

The Québec AMF has established an independent and specialised administrative tribunal for securities and derivatives (the *Bureau de décision et de révision* or BDR) to deal with nearly all administrative requests made by the Québec AMF.

The DFSA has established an administrative decision making framework which is not constrained by the quantum of fines that it may impose.

- 80.** Aggrieved parties in some jurisdictions may also bring their own actions before tribunals and courts to seek redress.

#### EXAMPLES

Many jurisdictions permit aggrieved parties (including by private right or class action), or regulators to join with aggrieved parties to pursue relief (including compensation), through the civil courts or administrative programmes for breaches of financial services laws and regulations.

Case law in the United States has established a private right of action for fraud in connection with the purchase or sale of securities,<sup>25</sup> and the US Commodity Exchange Act, administered by the US CFTC, explicitly provides for a private cause of action.

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<sup>25</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195-96 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972).



## Incentives, co-operation and settlement

81. Strategies that incentivise co-operation with regulators and enforcement agencies can bring investigations and enforcement actions to a speedy resolution and bolster the regulators' efforts towards deterrence.
82. The ability to enter into voluntary but enforceable agreements or undertakings, including co-operation, deferred and non-prosecution agreements with a party in order to obtain the evidence necessary to prosecute a more culpable party can be a timely and cost-effective approach to deploy resources and impose remedial measures, in addition to punitive sanctions.
83. Settlement agreements can be more flexible in securing a variety of outcomes and remedies, including the imposition of remedial actions to strengthen systems and controls and risk mitigation strategies or other undertakings not always available in civil or criminal judicial frameworks. Settlement agreements may also include admissions of misconduct, which can lead to greater accountability for the wrongdoer and greater clarity to investors and the public.
84. Regulators who are able to enter into voluntary but enforceable agreements or undertakings that provide for remedial action, as well as appropriate punitive sanctions, can achieve efficient outcomes that allow for the allocation of scarce resources to other risk areas.
85. When regulators have the authority to resolve issues through agreement, in appropriate cases, they can avoid the costs and complexities of administrative and court proceedings.

## EXAMPLES

The US SEC's Division of Enforcement has developed a series of measures designed to encourage greater cooperation by individuals and companies in US SEC investigations and enforcement actions. The programme provides incentives to individuals and companies who come forward and provide valuable information to US SEC investigators. The US SEC uses an analytical framework to evaluate whether, how much, and in what manner, to credit the cooperation by individuals and companies in its investigations and enforcement actions.<sup>26</sup>

Like many regulators, the UK FCA provides incentives to those who settle its investigations early by discounting penalties that would otherwise be imposed.

Many regulators have the power to enter into agreements with licensees/registrants in disciplinary proceedings<sup>27</sup> or to use other voluntary but enforceable undertakings or settlement mechanisms prior to the imposition of a final decision by a formal decision-making body, such as an administrative tribunal or a court. The UK FCA makes use of an instrument called a *Voluntary Requirement* and ASIC,<sup>28</sup> DFSA<sup>29</sup> and other regulators make use of enforceable settlement agreements called *Enforceable Undertakings*. These instruments allow regulators to achieve creative enforcement outcomes that may include remedies outside the normal range of sanctions.

26 See <http://www.sec.gov/spotlight/enfcoopinitiative.shtml>

27 Section 201 of the Hong Kong Securities and Futures Ordinance, available at <http://www.hkllii.hk/eng/hk/legis/ord/571/s201.html>.

28 Sections 93 & 93AA, Australian Securities and Investments Commission Act, 1989 available at <http://www.comlaw.gov.au/Details/C2005C00461>.

29 Article 89 - Enforceable Undertakings, Regulatory Law, DIFC Law No 1 of 2004 available at [http://dfs.complinet.com/net\\_file\\_store/new\\_rulebooks/d/DFSA1547\\_7446\\_VER170.pdf](http://dfs.complinet.com/net_file_store/new_rulebooks/d/DFSA1547_7446_VER170.pdf)

Outcomes can include remedies such as findings of fact, admissions of liability, disgorgement of ill-gotten gains, penalties, customer restitution and the removal of persons from key positions, and can result in early resolution of what would otherwise involve protracted court proceedings.

The Québec AMF makes use of a special committee (the CCMF unit or *Unité des crimes commis sur les marchés financiers*) to identify the most credible approach to cases which might be of interest to both law enforcement and the Québec AMF (i.e. cases with potential criminal, quasi-criminal and administrative aspects).

The US SEC has a new settlement protocol by which it will require admissions in certain cases where there is a heightened need for public accountability. For example, admissions may be required in cases in which particularly egregious conduct occurred, large numbers of investors were harmed, the markets or investors were placed at significant risk, the conduct obstructed the SEC's investigation, the admission can send a particularly important message to the markets, or the wrongdoer poses a particular further threat to investors or the markets.<sup>30</sup>

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30 See Chair Mary Jo White's Speech at the 41st Annual Securities Regulation Institute, 27 January 2014, available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540677500>

## Factor 5: Sanctions: Strong punishments - no profit from misconduct

### In brief

86. Regulators should have, and willingly use, a range of sanctions that are effective, proportionate and dissuasive. The sanctions should be greater than the cost of the misconduct so that the threat of the penalty removes the incentive for choosing not to comply. Sanctions should reflect the seriousness of the misconduct and aim to deter it. Sanctions that account for wrongful profits, compensate and restore victims and have an appropriate penal element can be expected to enhance deterrence. In addition, deterrence can be enhanced when individuals are held personally accountable for their actions.
87. Misconduct can be deterred when regulators:
- a) demonstrate a willingness to impose or seek the imposition of sanctions and remedies that are effective, proportionate and dissuasive;
  - b) have at their disposal sanctions that appropriately respond to a wide range of evolving types of misconduct;
  - c) have access to an appropriate range of administrative and judicial avenues for the imposition of sanctions;
  - d) advocate that their administrative and judicial decision makers be empowered with a suite of sanctioning powers and remedies that best address misconduct and the impact of that conduct;
  - e) hold individuals and entities, including those that are gatekeepers, such as accountants and lawyers, accountable;
  - f) seek practical and innovative sanctions and remedies that best serve the investors' and public interest;
  - g) in addition to pecuniary sanctions and as appropriate, seek to recover the cost of their investigations, prosecutions and litigation from those who burden society with their illicit and unethical practices.

### In detail

88. As a starting point, sanctions should seek to send the deterrent message that those involved in misconduct should not profit from it. IOSCO contends that sanctions should be effective, proportionate and dissuasive.<sup>31</sup>
89. Imposing sanctions that reflect the seriousness of misconduct should have a positive effect on deterring further misconduct. For instance, fines should not simply be a cost of doing business and recidivists should know that they will find themselves subject to tougher sanctions should they reoffend. A robust sanctioning regime provides a deterrent to misconduct if the potential costs of committing the violation are perceived to outweigh the potential benefits.

<sup>31</sup> *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf>*

90. Robust sanctions can act as a catalyst to encourage propriety and compliance with laws and regulations and standards of behaviour. The credibility of any deterrence programme relies on the resolve of those who are responsible for its administration. If regulators are not willing to impose or seek the imposition of sanctions that are effective, proportionate and dissuasive, or if the system of enforcement is ineffective or perceived to be weak then no matter how sound the rules are, the credibility of the regulatory framework could be undermined.

## EXAMPLES

Many regulators have broad powers to seek restitution, disgorgement of ill-gotten gains, penalties and other punitive sanctions for a wide range of misconduct. Some regulators have the ability to seek penalties that are tied to the number of times the misconduct has occurred or that are multiples of gains achieved or losses avoided for certain violations, such as insider trading and market manipulation. For example, L'Autorité des Marchés Financiers in France (France AMF) may seek penalties that are 10 times the profits made or loss avoided.

In 2010, the UK Financial Services Authority (now UK FCA) announced a new penalties regime for misconduct occurring on, or after, 6 March 2010. The new framework was intended to create transparency in the way penalties are set, improve the consistency of penalties levied and also increase the levels of those penalties to achieve credible deterrence. The regime consists of a five step process under three principles focusing on (i) disgorgement of profits made or losses avoided, (ii) discipline taking into account the seriousness, nature and impact of the breach and any aggravating or mitigating factors, and (iii) deterrence to the subject and the market.

The Québec AMF seeks prison terms for every case of fraud or misappropriation of funds.

In March 2014, ASIC issued its Report 387 *Penalties for Corporate Wrongdoing* which explored how the penalties available to ASIC for corporate wrongdoing compared with penalties available internationally. The report considered penalties in Australia, Canada (Ontario), Hong Kong, the United Kingdom and the United States. The purpose was to allow ASIC to calibrate its response to breaches of the law with sanctions of greater or lesser severity commensurate with the misconduct, with the stated aim to *deter other contraventions, and promote greater compliance, resulting in a more resilient financial system.*

Many regulators have the ability to make prohibition orders (e.g. excluding products from the market), direction orders, banning orders and stop orders, on a permanent or interim basis.

FINMA has the discretion to set the maximum variable compensation for specific individuals over a specified period. For example, in one case, FINMA limited the maximum annual variable compensation for employees involved in foreign exchange and precious metals at a global bank to 200% of the basic salary, for a period of two years.

## Setting of sanctions

91. Regulators should explore practical and innovative sanctions and remedies that best serve the public interest and the interests of investors and develop transparent criteria for the determination of sanctions and fines. Multifold sanctions may be necessary to deter certain behaviour.

## EXAMPLES

The SEBI initiated the establishment of a database, hosted by the Asia-Pacific Regional Committee (APRC) of IOSCO, to track and store sanctions data of regulators who volunteer it. This data is a useful source of information for regulators and administrative and judicial decision makers who seek guidance as to the appropriateness of sanctions and remedies imposed for a range of market abuse and financial services violations. The database is held on the IOSCO website and is available for APRC regulators to contribute to on a voluntary basis.

In insider trading cases, several regulators can obtain penalties that are multiples of the amounts of profit gained or loss avoided.

## Restorative measures

92. Competent authorities should consider the deterrent value of restorative measures that aim to compensate victims for their losses or restore them to the position they occupied before the misconduct occurred.
93. The restoration of victims and the acknowledgement of misconduct by wrongdoers are becoming more prevalent in the orders some regulators are seeking from judicial and administrative decision makers. Restorative measures focus on two principal themes: strengthening the accountability of the offender; and restoring the victim (as an individual person or entity, or society as a proxy victim) to their pre-misconduct position. The application of restorative measures to cases involving serious criminal offences may be effective in reducing recurrent misconduct. They can help promote the message that genuine accountability requires wrongdoers to do more than write a cheque.
94. Restorative orders may include orders for compensation, orders requiring the implementation of compliance or educative programmes, and reformative measures that involve the offender acknowledging their conduct and its impact. A measured and consistent strategy of seeking such orders in appropriate cases can assist to achieve credible deterrence.
95. In addition to other measures, recidivism may be reduced if there is rehabilitation assistance, including training, education, mentoring and other support from which offenders learn what good behaviour looks like and are able to discuss it with mentors or peers. Prison sentences alone will not prevent reoffending in all cases. Reoffending may be reduced if the offending party is required to adopt a range of remedial actions, some of which may be implemented after or concurrent with the punishment or sanction.

## EXAMPLES

A restorative measure has been successfully applied in Australia, where the senior executives of an insurance company that had mis-sold insurance policies, travelled to meet the representatives of indigenous communities, members of which had been mis-sold insurance policies, in order to fully apprehend and understand the harm done.

Many securities regulators have both civil and administrative authority to seek restorative orders including, for example, an order that was obtained by the HK SFC that required an issuer to repurchase shares sold to thousands of investors, where information within the prospectus was found to be misleading.

Belgian law introduces a rebuttable presumption for breaches of rules of conduct (such as mis-selling), so that investors no longer have to prove the causal relationship between the breach and the investment transaction. It is assumed that the investor would not have made the investment decision had the service provider not committed the breach. As a consequence, investors who have suffered losses because a service provider has committed a fault, will be more easily able to obtain compensation in court.

The British Columbia Securities Commission (BCSC), like its Canadian counterparts, uses *Victim Impact Statements* to assist sanction decision makers to make better decisions about proportionality. The BCSC collects information from victims which is collated and introduced as an exhibit at the Sanction Hearing to enable decision makers to better fashion a punishment to fit the crime.

The US SEC has authority to return funds to injured investors by allowing civil penalties and the proceeds of disgorgement to be included in *Fair Fund* distributions to investors harmed by securities violations.

96. Mechanisms that seek to ensure payment of pecuniary sanctions, such as the powers to order accountings, appoint receivers, and freeze assets, can enhance deterrence.
97. Sanctioning decisions should have regard to the context, nature, gravity, impact and victims of the misconduct and to the public interest. For example, to the extent possible and appropriate:
  - a) individuals and entities should be held accountable for, and not profit from, their unlawful acts or omissions;
  - b) penalties should constitute fines above and beyond unlawful profits;
  - c) investors should be protected and restored, by the perpetrator, to the position they occupied before the misconduct;
  - d) recidivists should be subject to more stringent sanctions;
  - e) remedies should seek to strengthen the integrity and governance of regulated entities and public companies;
  - f) the level of co-operation by wrongdoers should be considered in sanctioning decisions;

- g) the obstruction of investigations should be treated as an aggravating factor; and
- h) criminal sanctions should be available for egregious violations.

### Individual accountability

98. It is common practice for regulators to impose sanctions on institutions. However the conduct of institutions is governed and carried out by individuals. Therefore, regulators should consider whether it is appropriate to also hold those individuals accountable. Holding individuals accountable can reinforce acceptable standards of behaviour in individuals and institutions and can be a critical factor in deterring misconduct. Regulators should therefore consider developing a culture of accountability in their public messaging, laws, enforcement strategies and prosecutions to punish egregious conduct and reinforce compliant behaviour.

### EXAMPLES

Section 304 of the Sarbanes-Oxley Act allows the US SEC to hold individuals accountable by making CEOs and CFOs of public companies repay their company for certain compensation received during years when the company underwent an accounting restatement resulting from *material non-compliance* with financial reporting requirements, even if the CEO or CFO has not participated in the misconduct.

Whilst many jurisdictions have conferred on their competent authorities the *discretionary* power to bar persons from management functions in licensed financial institutions, Belgian legislation goes a step further by introducing an additional automatic bar within the financial industry on persons in management positions who have had a definitive criminal or civil sanction imposed on them. This means in practice that these persons are automatically barred from occupying effective management positions in banks or other financial institutions. The automatic bar following an administrative fine is for a period of 10 years.

The UK FCA has proposed changes to the way individuals working for certain authorised firms are assessed and held accountable for the roles they perform. In particular, the proposed amendments would allow the UK FCA to impose conditions, time limits and variations on the approval of the senior managers of certain authorised firms and are designed to promote a clear allocation of responsibilities to senior managers and enhance their individual accountability. Other changes have been proposed to introduce, in respect of certain senior individuals, a requirement for a minimum claw-back period for variable remuneration, and to enhance the ability of firms to recover variable remuneration even if it has been paid out or vested.<sup>32</sup>

99. Furthermore, regulators should consider holding individuals, who have important roles in financial activities and/or those that act as gatekeepers (e.g. compliance officers, accountants, auditors, officers/directors of public companies, etc), accountable as they underpin the integrity of institutions and the financial services industry and are the first line of defence in the detection and remediation of misconduct. Sanctions for these persons could include such measures as criminal and civil penalties, but also, as appropriate, delicensing/deregistration and bars to practice before the regulator, bars from the regulated industry, bars from officer or directorships of a public company and/or participation in the

32 <http://www.fca.org.uk/news/cp14-13-strengthening-accountability-in-banking> and <http://www.fca.org.uk/news/pr-14-01-and-fca-consult-on-proposals-to-improve-responsibility-and-accountability-in-the-banking-sector>

financial sphere. Another deterrent sanction for individuals is the claw-back of professional fees for services that facilitate misconduct and the claw-back of bonus and incentive awards that were derived from such conduct.

## EXAMPLES

Many regulators have authority to sanction, or to work with other regulators to sanction auditors, attorneys, sponsors and other gatekeepers for participating in securities violations or for failing to follow rules and duties of their profession or practice.

The DFSA held the entire Board of a publicly listed company accountable when it used its power to remove and ban the members of the Board, for a period of two years, following the discovery of serious governance failures within the company.

## Cost recovery

100. In some jurisdictions, securities regulators are publicly funded. Some governments have determined that the public should not have to pay for the failures and misdeeds of others. Where such public-funded enforcement action has resulted in a finding of misconduct, regulators in those jurisdictions may consider recovering the cost of their investigations, prosecutions and litigation from those who burden society with their illicit and unethical practices. Other jurisdictions might also consider developing efficient and effective cost recovery laws, policies and procedures to recover their costs as a factor in deterring misconduct. Would-be wrongdoers may think twice about violating the law if they know that they might be required to pay for the regulators' investigation, litigation and/or prosecution of the violation.

## EXAMPLES

The Qatar Financial Centre Regulatory Authority (QFCRA) pays the costs and expenses of an investigation, except if the person under investigation is found to have contravened a relevant requirement. In that case, the QFCRA or, where appropriate, the appeals body or tribunal may order that person to cover all or part of the costs and expenses of the investigation.<sup>33</sup>

Pursuant to the NZ Securities Markets Act, where NZ FMA obtains a pecuniary penalty award for insider trading and market manipulation it is entitled to first recover its investigation costs from the sum paid before the remaining penalty is paid to the Crown (central treasury).

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33 *Article 50 of the Financial Services Regulations, Version 2, effective 9 December 2010, available at [http://www.complinet.com/qfcra/display/display.html?rbid=1557&element\\_id=859](http://www.complinet.com/qfcra/display/display.html?rbid=1557&element_id=859)*



## Factor 6: Public messaging: Promoting public understanding and transparency

### In brief

101. Public messaging can deter misconduct when would-be wrongdoers know that regulators will publicise enforcement outcomes and sanctions imposed against individuals and entities. Regulators who communicate their objectives, mandates and enforcement outcomes, and seek and respond to feedback, engender public support for regulatory and enforcement programmes.
102. Misconduct can be deterred when regulators:
  - a) clearly explain their objectives and how they fulfil their mandates so that the regulated community and the public understand how and why regulations apply to them, how they are enforced and the consequences of non-compliance;
  - b) clearly set out the behavioural expectations for market and industry participants through the publication of enforcement outcomes supplemented by guidance and other communications where necessary;
  - c) make it known that individuals and entities will be held accountable for their actions;
  - d) enhance transparency and compliance by making public all final enforcement decisions, including the publication of the identities of persons and entities against whom sanctions are imposed;
  - e) issue public policies about the publication of investigation and enforcement actions; and
  - f) alert the public about misconduct and bad selling practices, and high risk products and services.

### In detail

#### Alerting investors

103. It is common practice for regulators to inform and warn the public about scams and other fraudulent activity. Some regulators use innovative and bold practices to educate, inform and alert the public to potential and ongoing fraud.

### EXAMPLES

Many regulators inform and warn the public about scams and other fraudulent activity including cloning, and identify theft through electronic alerts on their websites. For example, ASIC's *MONEYSMART* website contains warnings, information and education to financial investors and consumers about investment risks and financial scams. Furthermore, using funds recovered from the proceeds of crime, the UK FCA recently launched a national campaign known as *Scamsmart* (<http://scamsmart.fca.org.uk/>) to warn consumers about investment fraud, the tactics fraudsters use and how to spot a potential scam. The site also provides some basic advice to investors on what to do if they are targeted. The site also contains a warning list with the names of entities that the UK FCA believes to be targeting consumers to induce them to enter into fraudulent investments.

The US CFTC and ASIC have created fictitious websites and promoted fictitious scams designed to attract investors by using techniques frequently used by fraudsters. In the case of the US CFTC promotion, if a viewer clicks on any of the links, it directs the viewer to a screen that advises the viewer that the company and website are fictitious, and provides additional information on identifying potential scams. ASIC offered rewards to members of the public who were able to identify their scams.

The US SEC's Office of Compliance Inspections and Examinations provides the public with information on issues that it identifies through its National Exam Program that could be used to deter violations of the US federal securities laws. In addition, as a service to investors, the US SEC's Office of Investor Education and Advocacy provides *Investor Alerts*, focused on recent investment frauds and scams, and *Investor Bulletins*, focused on topical issues including recent US SEC actions.

IOSCO publishes alerts about misconduct provided by its members on its website.<sup>34</sup> This information is used by IOSCO members to identify, impede and stop misconduct before investors are damaged by it.

### **Transparent enforcement and accountability**

- 104.** Publicity of enforcement actions can be effective for deterrence when it clearly explains what went wrong, how the sanction was determined and why the conduct breached the regulator's rules and principles. Publicity in cross border enforcement cases can be particularly powerful when regulators coordinate the timing and content of their announcements.
- 105.** Public messaging can promote deterrence by demonstrating that there are tangible consequences for those engaging or contemplating engagement in misconduct.
- 106.** Regulators should, within their legal competence, consider publishing all final enforcement decisions including the identities of persons and entities against whom sanctions are imposed.
- 107.** Providing the legal and factual basis for enforcement cases can enhance public understanding of regulation and assist in managing expectations. Those seeking to understand and comply with regulatory obligations are better able to make judgments and govern their institutions, people and resources if they better understand the rationale for and consequence of enforcement action.
- 108.** Moreover, systems that inform the public about disciplinary actions against financial service professionals can have a strong deterrent effect particularly when individuals and entities are held accountable. Public messaging cautions that individuals and entities will be held accountable and that there are consequences for engaging in unlawful activity. Regulated persons can be expected to think twice before committing securities violations if they know their names and infractions are disclosed on a public record.

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34 [http://www.iosco.org/investor\\_alerts/](http://www.iosco.org/investor_alerts/)

## EXAMPLES

The UK FCA will not normally make public the fact that it is or is not investigating a particular matter before that investigation has reached the disciplinary stage. However, the UK FCA is permitted by legislation to publish *Decision Notices* and *Final Notices*, which provide detailed descriptions of the misconduct, the breaches and the penalty. Decision Notices are issued when the UK FCA has decided what action to take and Final Notices are issued when the matter has been concluded. The UK FCA can also publish statements about *Warning Notices*, which are issued at the end of an investigation and at the very start of the disciplinary process. Unlike Decision and Final Notices, Warning Notices are not published in their entirety and might not name the subject of the Notice, but they are an important aid to early transparency which has benefits for consumers, firms and market users. Publishing Notices is an important way for the UK FCA to show the behaviour that it considers unacceptable and encourage compliant behaviour, thereby enhancing confidence in the regulatory system. This practice also demonstrates openness about the enforcement process, which is important for the public interest.

### Timely publication

109. The timeliness of the publication of information about enforcement actions can deter those contemplating misconduct before it manifests into serious harm to investors. For example, regulators who alert the public about illegal schemes, unlawful fundraising activities, illegal selling practices, high risk products or misconduct, in a timely manner, are likely to deter misconduct and prevent consumers from being harmed.

## EXAMPLES

Many regulators routinely publish enforcement outcomes and the names of those who have been sanctioned. For its part, the Polish Financial Supervision Authority (KNF) acts proactively to educate and inform the public about actions and risks relating to the operation of the financial market and entities operating on the market by publishing warnings and announcements, and broadcasting them on radio and television, in order to protect the justified interests of financial market participants. Furthermore, the KNF may communicate to the public information about filings with the public prosecutor on suspicion of a breach of financial services legislation. This information will be supplemented with an update on the final and binding refusal to initiate the preparatory proceedings or on the final and binding discontinuance of the preparatory proceedings and, in the event of the filing of an indictment, with an update on the final and binding court ruling.

Regulators routinely publish documents that outline their strategic direction and objectives, and some regulators publish performance targets.

Many regulators also have good public policies about the publication of investigations and enforcement outcomes. For example, ASIC's website contains statements on its approach to enforcement, explains when it will comment publically on investigations, and reports every six months on its enforcement activities and outcomes, including specific areas of misconduct that are expected to be the subject of enforcement action in the next six months.

Some regulators publish information about the effectiveness of their enforcement programmes. For example the UK FCA publishes the *Enforcement Annual Performance Account* that includes statistical and background information about enforcement investigations and their outcomes. It

also provides an assessment of the fairness and effectiveness of the enforcement process, which includes feedback from entities and practitioners that have been involved in the enforcement process.

Some regulators promote public understanding of regulatory obligations through SROs. For example, some regulators work with their SROs to provide a variety of resources to assist the regulated industry and persons in meeting their regulatory responsibilities including regulatory guides, self-examination questionnaires, webinars, podcasts and video-casts and in-person workshops.

## Factor 7: Regulatory governance: Good governance delivering better enforcement

### In brief

- 110.** To keep pace with financial innovation and illicit practices, regulators should consider regularly evaluating and, as appropriate, revising regulatory and enforcement strategies, priorities and tools. They should also consider how they can identify innovative solutions and regulatory practices to keep pace with the complexities and challenges of domestic and transnational regulation and enforcement.
- 111.** Misconduct can be deterred when regulators:
- a) act to ensure regulation is well designed and governed;
  - b) have the capacity, competence, resources and resolve to investigate misconduct;
  - c) are independent and free from inappropriate political or industry influence;
  - d) regularly review and assess the effectiveness of their governance and organisational arrangements and make reforms where necessary;
  - e) have access to a variety of information, data and performance metrics, including information about the effectiveness of their enforcement programmes so that enforcement decisions can be made on an informed basis;
  - f) have appropriate levels of funding and access to skilled and experienced staff, intellectual capital, and innovative technology and practices;
  - g) look outside the field of enforcement to see what other innovative practices can be used to enhance deterrence;
  - h) are empowered with and have access to appropriate regulatory tools to fulfil their mandates;
  - i) understand the drivers of good and bad behaviour and design regulatory programmes, such as enforcement, to incentivise and sanction these types of behaviour, respectively;
  - j) measure, monitor and make public reports about their performance to enhance public understanding of their objectives and effectiveness.

### In detail

- 112.** Innovation in the finance industry has led to the development of new financial products and new ways of doing business. Also, those engaged in illicit practices often have the planning, resources, technology, capacity and guile to chance their involvement in misconduct. They can engage in cross border activities, conceal their identities, find refuge in poorly regulated jurisdictions, use advanced technologies and exploit weaknesses and gaps in legal and regulatory frameworks. They use innovative products, sophisticated techniques and technology to take advantage of unsophisticated investors and markets. Regulators need to innovate and develop to keep pace.

## Governance

113. Governments, the regulated community and investors expect regulators to deliver on their mandates and act in the public interest. Regulators can best fulfil their mandates if they are independent and free from inappropriate political or industry influence.
114. Regulators who have strong internal governance and decision making capacities and structures that provide robust oversight, promote independence and objectivity, foster specialisation and innovation, and facilitate information sharing and collaboration are likely to be more effective and, therefore, make a greater contribution to the deterrence of misconduct.
115. Regulatory design is often a function of the unique legal, economic, political and social environment in which regulation functions. Whatever the regulatory model i.e. twin peaks, integrated, industry-based or functional, enforcement programmes should adapt their structures to respond to current and emerging risks. There is no one-model-fits-all solution. However, many regulators are adopting structures that favour specialisation.
116. Regulators seeking to maximise credible deterrence should consider regularly reviewing and assessing the effectiveness of their governance and organisational arrangements, particularly in their enforcement programmes, and make reforms where necessary.

## EXAMPLES

Many securities regulators have created specialist investigation and enforcement units and make significant investments in market surveillance technology. For example, the Québec AMF created dedicated and specialised enforcement units, the Market Manipulation and Insider Dealing division and the Economic Crimes division, to facilitate more effective and efficient investigations by tailoring its practices to deliver better outcomes.

BaFin has developed specialized sections, within its securities supervision department, for securities markets analysis as well as market manipulation and insider dealing investigations that focus on these areas exclusively.

To enhance its effectiveness, the Canadian OSC Enforcement Branch set up a dedicated criminal investigation/prosecution unit with former police officers, former crown prosecutors, and others so it can: (i) conduct searches under search warrants; (ii) initiate quasi-criminal proceedings under the Securities Act (Ontario); (iii) co-operate with the police in investigations; and (iv) with the assistance of crown prosecutors, initiate proceedings under the Criminal Code of Canada.

The US SEC's Enforcement Division created an Office of Market Intelligence responsible for the collection, analysis, and monitoring of the hundreds of thousands of tips, complaints, and referrals received yearly. This office helps provide the resources and expertise necessary to keep pace with ever-changing markets and to more comprehensively investigate cases involving complex products, markets, regulatory regimes, and transactions.<sup>35</sup>

The Québec AMF created the Specialised Investigative Support Unit (SISU) to adapt to emerging risks and trends in product design and industry practices. The SISU is staffed with experts in various fields related to securities and derivatives and assists the Investigation Department (and

35 See US SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence, 13 January 2010, available at <http://www.sec.gov/news/press/2010/2010-5.htm>

other divisions of the Québec AMF) in understanding and addressing these risks and trends. Their assistance in addressing high level and case specific issues increases the effectiveness of the Québec AMF's investigations.

The US SEC has created a Financial Reporting and Audit Task Force dedicated to detecting fraudulent or improper financial reporting to enhance the Division of Enforcement's ongoing efforts related to accounting and disclosure fraud,<sup>36</sup> and a Microcap Fraud Task Force that targets abusive trading and fraudulent conduct in securities issued by microcap companies, especially those that do not regularly publicly report their financial results.<sup>37</sup>

The UK FCA's Strategy and Competition Division acts as the UK FCA's radar in terms of spotting problems in financial markets early and designing strategies to solve them. It plays a vital role in enabling the UK FCA to act quickly and decisively when market issues appear on the horizon, and in delivering the UK FCA's mandate to promote effective competition. The Strategy and Competition Division shares intelligence and analysis with other areas of the UK FCA to make smart policy and strategy proposals. The UK FCA's Enforcement and Market Oversight Division also has a substantial strategy team which is responsible for ensuring that the Division's strategy, policies and engagement are innovative and relevant. This team's responsibilities include the development and analysis of performance metrics, obtaining feedback from external stakeholders about the effectiveness of enforcement outcomes, liaising with international counterparts in the development of policies and strategies around international cooperation and in terms of specific cross border cases, feeding into the legislative process at both the national level as well as the European level, and generally ensuring that the Division has the right powers, processes, policies and resources.

The US SEC's Center for Risk and Quantitative Analytics employs quantitative data and analysis to identify high-risk behaviours and transactions and to support initiatives to detect misconduct, increasing the Division of Enforcement's ability to investigate and prevent conduct that harms investors.<sup>38</sup>

The UK FCA has recently launched an initiative known as *Project Innovate* to support UK businesses that are developing products that could improve services for consumers. This initiative provides for, *inter alia*, UK FCA assistance in preparing applications for authorisation and help in understanding the regulatory framework, and is intended to identify areas where the regulatory framework could be adapted to allow for further innovation in the interests of consumers.<sup>39</sup>

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36 SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis, 2 July 2013, available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171624975>

37 *Ibid*

38 *Ibid.*

39 <http://www.fca.org.uk/firms/firm-types/project-innovate>

## Prioritisation

117. The prioritisation of cases and the allocation of enforcement resources is a challenging exercise in an environment of increasing regulatory scope and a resource base that is constantly stretched. To make more efficient use of scarce resources some regulators have implemented programmes which allocate enforcement resources to activities that pose the most risk to investors and the markets.

### EXAMPLES

Many regulators adopt a risk-based approach to enforcement, use risk assessment tools to analyse and evaluate risk and allocate resources to the most important problems and solve them. Co-ordination of risk and strategic intelligence analysis is critical to ensuring that priority is given to the risks likely to cause more harm to the financial markets and investors.

The NZ FMA also has a robust strategic intelligence operational model which places a strong emphasis on risk-based regulation. This ensures that the NZ FMA has the ability and infrastructure to identify the most important detriments facing the market and the ability to select the right tools to fix them. The collation and analysis of market and internal data and information to develop risk-based entity models is at the centre of the NZ FMA's approach to regulation including enforcement activities. Business analysts from the strategic intelligence unit work along-side the enforcement team to ensure that data and information is taken into account in enforcement activities and the setting of priorities.

118. Having access to data and metrics can enable regulators to better assess and determine priorities. Once priorities are determined then enforcement strategies can be designed and implemented. Several regulators have established research units to collate and analyse such information. Complaints and surveillance databases and programmes are useful sources of information.

### EXAMPLES

The US SEC tracks performance indicators to understand how it is using its resources to meet its objectives. One of these indicators assesses the quality of the cases filed by the US SEC's Division of Enforcement that involve factors reflecting enhanced risk to investors and markets. Such cases may involve: (i) those identified through risk analytics and cross-disciplinary initiatives to reveal difficult-to-detect or early stage misconduct, minimising investor loss and preventing the spread of unlawful conduct and practices; (ii) particularly egregious or widespread misconduct and investor harm; (iii) vulnerable victims; (iv) a high degree of scienter; (v) involvement of individuals occupying substantial positions of authority, or having fiduciary obligations or other special responsibilities to investors; (vi) involvement of recidivists; (vii) high amount of investor loss prevented; (viii) misconduct that is difficult to detect due to the complexity of products, transactions, and practices; (ix) use of innovative investigative or analytical techniques; (x) effective coordination with other law enforcement partners; and/or (xi) whether the matter involves markets, transactions or practices identified as an enforcement priority, or that advances the programmatic priorities of other US SEC Divisions or Offices.<sup>40</sup>

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40 US SEC FY2015 Annual Performance Plan, available at <http://www.sec.gov/about/reports/sec-fy2015-annual-performance-plan.pdf>



- 119.** A challenge for regulators is to determine the allocation of resources to act on a proactive basis, i.e. to prevent or deter misconduct before it occurs, or on a reactive basis, i.e. to deter further misconduct through investigations, prosecutions, sanctions and remedial programmes after misconduct has been detected.

### **Capacity**

- 120.** Regulators are increasingly asked to deliver to a higher standard. Better regulation requires access to an appropriate balance of skilled and experienced human resources, technology and innovative solutions.
- 121.** Credible deterrence is difficult to achieve without a foundation of appropriate levels of funding and access to: skilled and experienced staff; intellectual capital to keep abreast of financial innovation; and innovative technology and practices to allow regulators to fulfil their mandates. Resourcing within regulators should recognise the value of retaining appropriately trained, qualified and skilled staff.
- 122.** Several assessments including those carried out by the International Monetary Fund (IMF)<sup>41</sup> have identified that underfunding of regulators and regulation is a significant impediment to the effectiveness and credibility of regulatory and enforcement programmes. Underfunding diminishes the capacity of regulators to deploy resources and staff who are sufficiently skilled and experienced to meet the challenges of contemporary regulation and hinders the capacity of regulators to prosecute successful cases that enhance credible deterrence.

### **Strategy**

- 123.** The globalisation of finance and business has made unilateral approaches to enforcement less effective in some circumstances. To be effective and to deter misconduct, regulators require the capacity to regulate domestic and transnational transactions and business activities. To achieve this, regulators should consider developing strategies and relationships with domestic, national and global authorities. Regulators should consider having a broad but well defined remit supplemented by robust domestic powers and extraterritorial practices, as appropriate, to enable regulators to respond to the globalisation of misconduct.
- 124.** Strategies should seek to prevent misconduct before it occurs, reduce the cost of regulation and augment deterrence programmes. Strategies that encourage voluntary compliance with obligations can be as, or more, effective than strategies based on enforcement and punishment alone. Regulators should therefore consider the appropriate mix of proactive and reactive strategies, and how to maximise efficient communication and cooperation between those engaging in each programme.

### **Innovation**

- 125.** Financial and technological innovation has made it increasingly challenging for regulators to track and keep pace with transactional information flows and financial products and services which are increasingly complex, specialised and transnational. Therefore regulators should seek to continue meeting the challenges of the market by: keeping pace with market innovation; identifying and resolving regulatory vulnerabilities; deploying effective enforcement strategies; and by developing intellectual and technological capacities.

- 126.** Forward looking regulators can look outside the field of enforcement to identify innovative practices that can be used to enhance deterrence, maintain the currency of their understanding of new financial products and technology in the market and liaise with international counterparts to share ideas and innovative practices. Regulators need to keep innovating in response to emerging risks and adopting innovative technologies and strategies that best deter misconduct.

## EXAMPLES

The France AMF investigators and inspectors are lawfully authorised to use a false identity on internet websites to gather information on suspicious matters. This new tool can be used in two ways: firstly, to ensure that intermediaries comply with the rules and, secondly, to review practices relating to the selling of financial instruments.

The Belgian FSMA, under regulation to come into effect in 2015, can impose the use of labels to increase the transparency of the risk of certain financial products. Product providers will be required to specify, by colour labelling, the level of risks relating to any financial investment and savings products they bring to market. The regulation specifies the technical criteria to classify products and the way in which the label will be displayed.

## Specialised Enforcement Tools

- 127.** A range of tools are available to help regulators achieve credible deterrence, for example by employing innovative research and planning tools to properly plan and manage enforcement activity, including through discovery work, forecasting and market studies. Regulators should consider use of the latest market monitoring and alerting software to detect market misconduct. Furthermore, electronic tools such as digital forensic technology and e-discovery<sup>42</sup> may assist investigations and prosecutions.
- 128.** It is a combination of regulatory strategy, tools and resources rather than any one part which determines the overall effectiveness of securities enforcement.<sup>43</sup> To remain with, or ahead of, prevailing unlawful practices, regulators can regularly review their enforcement strategies and practices and retool their kits with innovative and effective powers. Factor 4 - Comprehensive Powers - contains examples of some useful powers some jurisdictions have applied to remediate and sanction illegal conduct.

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42 *E-discovery is an abbreviated term for electronic discovery. It is the obligation of parties engaged in legal proceedings to exchange documents that exist only in electronic form.*

43 *Assessing the Effectiveness of Enforcement and Regulation, CRA International, City of London, April 2009, p5, available at <http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2009/Assessing%20the%20Effectiveness%20of%20Enforcement%20and%20Regulation.pdf>.*

## EXAMPLES

Many investigations, in particular complex cross border investigations, frequently involve the urgent processing of complicated evidence and information in electronic files. Information and documents obtained from persons under investigation often have to be uploaded on to regulators' internal evidence management systems. To make this quicker and more efficient, the UK FCA has developed a standard template and standard data formats which are used when requesting documents and information; the UK FCA also liaises closely with entities under investigation to ensure that the data is provided in the right format and to agree workarounds where this is not possible.

Many regulators now use risk assessment tools to measure and monitor risk in entities under their supervision. Furthermore, some regulators utilise robust investigation planning processes built upon the framework of project management methodologies.

The Indian SEBI has put in place a *Data Warehouse and Business Intelligence System* (DWBIS) which involves extensive usage of the latest data warehousing and business intelligence technologies to support a far wider range of capabilities including historical data analysis, transaction based reporting, trading pattern recognition, fraud detection and establishing connections among clients. DWBIS comprises data warehouse, data mining and business intelligence tools. This upgraded surveillance mechanism implemented by SEBI is intended to effectively supervise market activities in a comprehensive manner.

### Measuring effectiveness

129. Regulators who measure, monitor and make public reports about their performance can enhance public understanding of their objectives and effectiveness. It is common practice for regulators to publish reports about their enforcement programmes. The metrics used to assess and measure effectiveness differ among regulators. Some common quantitative metrics include the number and type of investigations completed, prosecutions filed, persons sanctioned and amount of sanctions imposed.
130. By their nature, qualitative measures, such as whether enforcement action has improved market behaviour, are difficult to perform. Even when a regulator might perceive that it is achieving credible deterrence and changing behaviour, it can be difficult to identify whether enforcement action is the principal causal factor or whether there are external factors at play. Regulators are trying to develop more sophisticated measures to improve their effectiveness and plan strategies for the future (sometimes known as second generation metrics).
131. Some ideas for measures that go beyond simple output metrics and attempt to measure strategic effectiveness are suggested below. Regulators may wish to consider whether these measurement tools add insight and value to their deterrence efforts.
  - a) **Observable data:** This practice involves the analysis of trends in behaviour by observing and measuring what happens in the markets. For example, market cleanliness statistics count the number of potential suspicious market transactions that occur immediately before a company announcement and compare that data to actions against market abuse or insider dealing taken by the regulator. Another example is the number of audit reports qualified for client money reasons.

- b) Feedback: This practice involves gathering feedback from stakeholders on credible deterrence and changing behaviour – it is essentially asking people how the regulator is doing. Collecting feedback can be done in a number of ways, such as by questionnaires and surveys, in meetings and conferences, directly or through advisors or lawyers or groups or panels, as part of the supervisory or enforcement process, or by tapping into former regulators who have gone out into industry.
- c) Media mining: This practice involves the use of sophisticated analytical tools to measure media reaction, not just in column inches but whether the reaction is favourable (that is, whether it is supportive, or whether the regulator’s key messages have been understood) in both traditional and social media.
- d) Econometric modelling: This discipline is a forecasting technique that uses mathematical equations and statistics (based on historical data and/or relevant assumptions) to predict future economic conditions and to help direct marketing or communications spending to where it will have most impact. This modelling also can be employed to determine the economic impact of enforcement actions and policies.

132. IOSCO’s *Key Elements in the Assessment of an Effective Enforcement Programme*,<sup>44</sup> identifies some criteria by which the effectiveness of enforcement programmes may be assessed.

## EXAMPLES

In March 2006, the UK Financial Services Authority (now UK FCA) issued *Occasional Paper 23 Measuring Market Cleanliness* which proposed measures of market cleanliness based on the extent to which share prices move ahead of the regulatory announcements that issuers are required to make to the market. The paper examined two broad kinds of announcement: those relating to take-over bids; and those about the trading performance of FTSE350 listed issuers. The UK FCA examined whether movements that were abnormal compared to a stock’s normal movement might reflect insider trading. The UK FCA now publishes these statistics annually.

The UK FCA publishes an *Enforcement Annual Performance Account (APA)* at the same time as its Annual Report and Accounts every year. This APA looks at the fairness and effectiveness of the UK FCA’s enforcement function over the financial year and summarises the activities and achievements of the Enforcement function in the previous 12 months. It also considers feedback from entities that have been investigated and lessons learned from investigations so as to continually enhance and improve the enforcement function.

<sup>44</sup> *Non-public Report of IOSCO Committee 4 for Enforcement and the exchange of Information, (IOSCO member’s only webpage).*

The UK FCA's Enforcement and Financial Crime Division offers feedback meetings to those who have been the subject of a concluded regulatory (but not criminal) investigation. The purpose of the feedback meeting is not to discuss the merits of the case or the outcome of the investigation, but to explore how the enforcement process has worked. The feedback meetings are also used to ask questions about the impact of the enforcement action on the entity or person concerned, such as whether they have put in governance, systems or process improvements as a result of the enforcement action, and the impact of other enforcement actions, such as whether enforcement *Final Notices* are discussed in compliance meetings or at Board level. The reports of these meetings are used to consider whether any changes should be made to enforcement's processes or strategy and are reported on in anonymous summary format in the UK FCA's Enforcement and Financial Crime Annual Performance Account.

The US SEC's Division of Economic and Risk Analysis uses analytical approaches, methods, and models in order to identify trends, risks or potential securities law violations in the capital markets.

### Understanding behaviour

133. Deterrence in securities regulation can be maximised when regulators understand the drivers of good and bad behaviour and design regulatory programmes, such as enforcement, to incentivise and sanction such behaviours respectively.
134. Behavioural economics is an innovative tool which enables regulators to better understand the factors that influence investor decisions and the drivers of entity behaviour. Such insight may prove helpful in the early identification of risks and discourage certain risky and/or violative practices employed by entities.

### EXAMPLES

The UK FCA uses behavioural economics to understand changing investor behaviours, and in so doing aims to intervene in markets more effectively, and in new ways, to counter inappropriate business models and to secure better outcomes for investors.<sup>45</sup> It has also conducted research into how to encourage consumers who may be due redress to respond to letters from financial firms concerning redress exercises. This has involved using behavioural economics to improve the drafting of such letters in order to ensure the highest possible response rate.

The Netherlands Authority for the Financial Markets (Netherlands AFM) applies its ISAD *framework* to analyse the underlying drivers of behaviour by examining Internal norms, Social norms, Ability to comply and Deterrence as the underlying drivers of behaviour. It is a tool that assists the Netherlands AFM to analyse why institutions display non-compliant harmful behaviour. The objective of the framework is to promote structural and long-lasting changes to behavioural patterns present in the financial services industry or within institutions and therefore change behaviour to promote lasting compliance. The Netherlands AFM believes the *ISAD framework* is an essential ingredient for an effective problem-solving regulatory strategy.

45 See the discussion in the UK FCA's Occasional Paper No.1 *Applying Behavioural Economics at the Financial Conduct Authority*, April 2013, available at <http://www.fca.org.uk/your-fca/documents/occasional-papers/occasional-paper-1>

See the discussion in the UK FCA's Occasional Paper No.2 - *Encouraging consumers to claim redress: evidence from a field trial* available at <http://www.fca.org.uk/your-fca/documents/occasional-papers/occasional-paper-2>

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