Are Court Prosecutions really the best strategy for Financial Regulators?

One message coming out of the Royal Commission is the view that our financial regulators should prosecute financial firm misconduct via court actions rather than using strategies of negotiation, agreed penalties and enforceable undertakings. The arguments for doing so relate to both punishing wrongdoers and the general deterrent effect of publicised court determined punishments on other potential wrongdoers.

The view that we would have had better financial sector behaviour if a more "heavy-handed" prosecution-based approach had been followed is however an unproven (and probably unprovable) assertion. It may be true, but there are at least three good reasons for thinking that the "softly-softly" approach has some merit.

First, in cases of burglary, assault etc., the victim knows that the wrongdoing has occurred and will (generally) initiate action via reports to the authorities. But in many of the cases considered by the Royal Commission, the victims were not aware that wrongdoing had occurred. Bad financial advice, fees for no service, sales of inappropriate financial products, excessive (hidden) commissions and fees are examples.

Nor, it is claimed, were the boards and senior executives of large financial firms initially aware that their governance, remuneration, and "cultural" strategies were leading to systematic wrongdoings by their staff.

The question then is how are these types of wrongdoings to be brought to light and dealt with? External independent investigation (such as by journalists following up tips from financial consumers or competitors who have perceived wrongdoing), investigations by financial regulators, or self-reporting by institutions or whistle-blowers among their staff, are the main avenues.

Arguably, institutions may be more willing to self-report (and dob-in other miscreant firms) once wrong-doing is recognised by senior management if negotiated settlements rather than court prosecution is a consequence. Particularly where the behaviour is in the grey area of "maybe not compliant" with regulation or community standards, senior management may respond to potentially higher penalties by non-disclosure in the hope of non-exposure.

The second reason is that financial regulation ranges between "black-letter law" and "principles based" regulation. In the former case, acceptable and unacceptable behaviour are clearly distinguished and prosecutions can be readily launched (if deemed more appropriate than reaching some form of negotiated settlement).

Principles based regulation has the advantage of allowing financial firms the flexibility to decide on the way in which they will act consistent with achieving the objectives of the regulation. But, determining whether some form of conduct is consistent with the objectives of the regulation is more problematic. And the regulator and regulated firm may have different views on this!

Consequently, negotiation between regulator and the regulated firm to achieve behavioural changes deemed required by the regulator, and to impose some penalty where past behaviour was clearly inappropriate, seems more appropriate than court actions. Courts are good at dealing with issues which are black and white, less so when there are many shades of grey.

The third reason is that prosecution can be extremely expensive in terms of resource costs (for both parties) relative to the alternative approach of negotiated settlements and enforcement actions.

And potential outcomes can be uncertain and different from what regulator and the regulated firm might otherwise agree on (as the recent Westpac rate-fixing case shows). Speed of resolution is also an important issue.

None of this is to say that the past approach of Australian financial regulators, involving relatively few court actions, has been the right one. It also seems apparent that the approach adopted has not involved as much transparency and publicity as might be desired to achieve a better general deterrence effect.

But there is the risk of the pendulum swinging too far in the opposite direction. Finding the right balance between the "heavy handed" court-based and the more "softly-softly" negotiated settlement approach, and determining the best *modus operandi* for each are the challenges facing our financial regulators.

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