

# **Financial Regulation Enforcement and the Criminal Dimension:**

*Irish Perspective, EU Context*

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## **Abstract**

Criminal law and regulation constitute a binary divide which police the financial regulatory control domain. Pre-crisis financial regulation in both Ireland and the European Union failed leading to reform calls and for an expansion of the criminal law dimension. Returned to the aegis of the Central Bank in 2010, the Irish Regulator established a new dedicated Enforcement Directorate and introduced a new Enforcement Strategy promising that criminal prosecutions will be pursued in all appropriate cases with increased penalties sought. Within the European Union the Commission itself has engaged in a new centralised process of enforcement and sanctioning standard setting and rule convergence; has emphasised the 'signalling' importance of imprisonment for serious crime; and financial regulatory enforcement based on effective, proportionate and dissuasive sanctions is regarded as one of four intrinsically linked priority principles grounding reforms. In Ireland and the European Union a reform convergence or commonality has emerged which potentially will impact globally.

**Key Words:** Criminal Law, Financial Regulation, Enforcement, Reform, EU Convergence

## **Introduction**

Criminal dimensions of enforcement illuminate the tension between the market preference for administrative sanctioning and new reform demands for increased criminal law involvement within the financial regulation sub-domain. Criminal law and regulation are a binary divide policing the control domain for the financial services market, where Ireland, subject to political, economic, legal, and market influences, lies within a double European Union (EU) cocoon of Euro-zone membership itself within the wider Community populated by twenty-nine separate criminal justice

systems. This paper examines this tension within the reform agenda tasked towards seeking an Irish/EU commonality. Set against the aftermath of the 07-09 financial crisis, the unique position of Ireland, and the future EU approach which has major international implications, are explored for themselves and juxtaposed against other jurisdictions.

Commencing with an exploration of background influences within the financial regulation domain, schematically this overview paper highlights the essential importance of enforcement within this complex and dynamic sector as found in both Ireland and the EU. Criminal law and regulation binary tension is discussed and traced through both a new conceptualisation and the operational enforcement pyramid which is derived from the responsive regulation approach. Financial regulatory reform actions are described and explored, conclusions are drawn and outstanding issues identified.

Enforcement reform is an essential reform pillar. The methodology is the enforcement pyramid where criminal law sanction is sandwiched between administrative regulatory options. Post-crisis there have been calls for greater criminal law involvement. EU innovation will affect all 29 criminal justice systems, including Ireland, and influence many others internationally. The importance of these developments cannot be understated.

## **Background influences**

Ireland's history of financial regulation has been inextricably wedded to both foreign and political influences and the banking industry with its endemic scandals and failures. In 1942 the Irish Central Bank was statutorily established<sup>1</sup> based upon the British model. For Ireland since the new millennium, the most significant change to formal institutions of regulatory governance has been the establishment of statutorily independent regulatory agencies, such as the Financial Regulator in 2003<sup>2</sup>. Similarly Ireland's history of criminal justice bears a heavy British influence, both at common law and statutorily.

In EU terms the adoption of the international Treaty known as the Single European Act 1986 presaged numerous pieces of legislation described variously as 'the emergence of an EU regulatory state', or perhaps better described as an instance of 'regulatory capitalism' (Braithwaite, 2008). Many of these related to financial services, for instance, capital adequacy, information transparency, market abuse, competition law, and investment vehicles. Moloney (2008) has described a 'juggernaut' of EU legislation which required national transposition and still does.

The financial regulation sub-domain is concerned with increasingly complex financial products and institutions and adaptive and innovative markets (Regling and Watson, 2010: 17). Further, the long promulgated

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<sup>1</sup> Central Bank Act 1942

<sup>2</sup> Central Bank and Financial Services Authority of Ireland Act 2003

creation of an integrated, open, competitive, and economically efficient European financial market requires convergence of national sanctioning regimes. Financial regulatory enforcement, based on 'effective, proportionate and dissuasive' sanctions, the concept grounded in the Greek Maize case<sup>3</sup> and utilised in financial regulation in both Ireland and the EU, is regarded by the EU Commission as one of four intrinsically linked priority principles grounding post financial crisis reforms (EU COM, June 2010/301: 4).

### **The control domain**

Regulation is 'government in miniature' control of policy objectives by central instrument, generally by the use of rules or principles, and a public administrative policing of private activity (Mitnick, 1980; Prosser, 1997; Prosser, 2010). Regulation defines the domain border - the control domain - between government and, in this instance, the financial market where the prime objective is risk analysis and risk reduction (Foy, 1998).

Financial regulation is a sub-domain weighed down by systemic risk (Seve, 2010). While, tasked to maintain trust in the pyramid of breakable financial promises (Wolf, 2010), the financial regulator has two distinct objectives or mandates: first, 'Prudential' to avoid a systemic failure of the banking system particularly; and second, 'Consumer Protection' to counter the particular problem of asymmetric information. The main types of financial services regulated in Ireland - and since November, 2010 covered by three EU supervisory watchdogs - include banking, insurance, securities and asset management.

The catalyst for Irish financial services regulatory reform in the 1990s was an international movement to establish stand-alone regulators (Gilardi, 2008) and a series of financial failures and scandals, including the NIB and Ansbacher (both bank) and DIRT (tax) scandals. The replacement of the old Central Bank regime was recommended by the McDowell Report<sup>4</sup> which outlined that Ireland needed a "dedicated first class regulatory authority operating to high standards". This report set off a lobbying clamour from the banks and other financial services firms. Following a political fudge on the 1st of May 2003 (Westrup, 2007; Regling and Watson, 2010) the hybrid Financial Regulator - the Irish Financial Services Regulatory Authority (IFSRA) - was established as the regulator. Later by the Central Bank and Financial Services Authority of Ireland Act 2004 statutory amendment sanctioning powers were granted, effective August 2004.

The Irish regulator however failed, was too 'deferential', effectively 'captured', and operated a 'retreatist' regulatory enforcement style (Honohan, 2010: 46, 59-60; McAllister, 2010:61). In essence, the 'soft-touch' Irish regulatory approach was 'deferential' to the industry and

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<sup>3</sup> Case C 68/88 Commission v Greece [1989] ECR 2965 (Greek maize case)

<sup>4</sup> Advisory Group on the Establishment of a Single Financial Regulator established 1998, otherwise known as the McDowell Report, 1999, especially at chapter 6.

political concerns, attempts to strengthen the approach had limited effect, key governance architecture elements were not put in place, 'retreatist' sanctioning was only reluctantly applied to micro-prudential functions, regulatory resources were demonstrably limited, and important regulatory principles were never codified. The Irish banking system imploded with massive private debt becoming sovereign debt. Thus, in June 2010 a new targeted risk focused regulatory approach was announced, with institutional change when the regulator returned to the aegis of the Central Bank<sup>5</sup>.

The EU system of governance, where economic motivations are prevalent, is the most developed and progressive trans-national system in the world (Majone, 1994, 1997; Levi-Faur, 2010). Ireland, a member of the inner Euro-zone cocoon, lies within the wider vertical and horizontal EU relationship, with a mix of EU and member state institutions and procedures. According to Donnelly (2010) these include new consultation, co-ordinating and supervisory structures, legitimate national variations in economic and social policy, a single integrated market, a bottom-up norm formation approach where norm convergence is non-uniform, and three separate policy regimes for companies, financial markets and accounting standards.

### **The binary divide**

Criminal law/justice and regulation constitute a binary divide (Wells, 2010) being separate but inseparable, and inter-dependent. Criminal justice historically set the pattern for regulation, indeed criminal law regulation of markets may be traced to medieval times, while an array of Nineteenth Century statutory interventions established new regulatory crimes (Scott, 2009). At core the spine of both paradigms is a mirror image: control rationale; crisis response; institutionalized; principled; legally grounded; contract underpinned - although the detail differs and sometimes significantly. Wells (2010: 373) has recently clarified this difference through the lens of sanctions:

Regulation can involve civil or criminal penalties. It is distinguished from criminal law – which applies across the board – in two ways: it targets those engaged in specialised activities and its underlying purpose is said to be different in that regulation seeks to mould or encourage behaviour rather than condemn it.

Scott (2009) has argued regulation a 'bifurcation' in the criminal law, and highlighted differences between 'real' and 'regulatory' crime, due in part to the absence of *mens rea* in strict liability offences, but also in investigation, prosecution, function, defences available, sentencing, and enforcement style.

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<sup>5</sup> Central Bank Reform Act 2010

For Zedner (2004:64) “Practices of enforcement are essential to understanding the reality of the criminal law, and, by implication, crime”. Lacey (1985:460) posed two questions under the rubric of defining ‘criminal law’: should the accused be punished for what is alleged and, if so, how severely?

But a new vision or pattern of criminal law intervention, and one increasingly utilised in administrative regulatory sanctioning, has more recently emerged.

### **The enforcement context**

Increasingly crime is being reconceptualised – with the emergence of a new pattern - from economic influences beyond the normal criminal law rationale of abnormality or deviance (Zedner, 2004). There has been a consequent shift towards engineering prevention involving surveillance and security, what Zedner otherwise called ‘preventive governance’. This prevention amounts to an actuarial justice (or economic) assessment or targeting for high-risk categories which includes white collar financial service criminals. The tactics of reactive risk are applied, exemplified by the 40 percent reactive effort in Ireland’s new regulatory enforcement strategy (2010) more fully explained later. Another tactic is the signalling or ‘messaging’ of the price of crime - effectively the sanction tariff - to potential offenders. Reflections in financial regulation both in Ireland and the EU (and elsewhere) find an increasing shift post-crisis towards stability mechanisms converging upon risk, systemic risk, such as the European Financial Stability Facility (EFSF) heavily active in the Euro-zone crisis; and, targeted risk-based regulatory approaches which target financial service firms according to risk hazard with the most risky gaining greater regulatory attention.

In considering the regulation of financial services and the criminal dimension, the EU Commission (COM, 2010/716) has recently highlighted the following six important issues: the ‘interplay’ between administrative and criminal sanctions imposed at member state level; that criminal sanctions, and in particular imprisonment, generally send a strong message of disapproval; that existing EU financial services law is without prejudice to the right of Member States to impose criminal sanctions; that criminal sanctions may not be appropriate for all types of financial regulatory violations and in all cases; that it will assess whether and in which areas the introduction of criminal sanctions, and the establishment of minimum rules on the definition of criminal offences and sanctions may prove to be essential; and, that in such endeavour it will target ‘coherence and consistency’ across different sectors, in particular when considering the type and level of criminal sanctions included in EU directives.

## **The Pyramid Strategy**

Gunningham (1987) a quarter of a century ago categorised two main enforcement strategies: confrontational deterrence and co-operative compliance. These were amalgamated from the Australian experience, principally by John Braithwaite for business regulatory purposes and became known as the hybrid 'Responsive Regulation' (Ayres and Braithwaite, 1992). This conceptualisation - which mixes punishment and persuasion, and more recently restorative justice (Braithwaite, 2002) - has over the last two decades been globally adopted by regulators.

The principal framework advocated by 'responsive regulation' from a sanctioning viewpoint is the Enforcement Pyramid. Enforcement strategies within such practise have been arrayed in a five level ascending and descending dynamic pyramidal approach, with criminal penalty a rung or two below apex where the removal of authorisation or licence lurks, and where the objective is to maintain as much enforcement activity as possible at the 'persuasion' base of the pyramid.

Ireland, like the EU where it has competence, has favoured an administrative approach to sanctioning. A survey of the thirty-three settlement agreements<sup>6</sup> entered into between the Irish financial regulator and regulatees between the commencement of sanctioning in 2004 and February, 2011 revealed an enforcement pyramid broadly in line with the 'responsive regulation' model with criminal penalties absent however, since like the UK there is a double jeopardy administrative and criminal procedure prohibition<sup>7</sup>, and with revocation, disqualification, fine and reprimand as the downward flow. This is a far cry from the more menacing US parallel proceedings approach (Brightman, 2009), which allows for simultaneous or successive investigations, prosecutions, or other actions brought against a person, a corporation, or some other entity by federal and state governmental departments or agencies, or by a government entity and a private party.

Farrell (2010) has argued that, because the legislative structure of the Irish criminal justice system is geared almost exclusively towards the prosecution of non-regulatory crime all prosecutors are bound by the considerations which bind public rather than regulatory prosecutors, resulting in the history of regulatory prosecution being modest in scope and effect. Indeed, the Central Bank's own Strategy Document (2010) issued in December 2010, post reforms, clearly re-states a preference for Administrative Sanctioning over summary criminal prosecution, although criminal prosecutions will be pursued it is stated in exceptional cases and where necessary will be pursued in all cases (2010).

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<sup>6</sup> see [www.centralbank.ie](http://www.centralbank.ie)

<sup>7</sup> Section 33 AT 1942 Central Bank Act 1942, as inserted by Central Bank and Financial Services Authority of Ireland Act 2004; and see McGinn, Dominic, "An Overview of Banking Regulation", a paper delivered at the Irish Criminal Bar Association White Collar Crime Conference, 25th March, 2011 held at The King's Inns, Dublin, at p 9

Public consultations upon this strategy area were promised for 2011 in Ireland just as in the EU. No Irish consultation has yet taken place. The Feedback Statement<sup>8</sup> prepared by the EU Commission recited inter alia that although there was general agreement that criminal sanctions could considerably increase deterrence, there was disagreement about their use, and even those agreeing appeared to favour strict conditionality and application to ill-defined 'serious offences' only.

### **Reformation Irish style**

In March 2008 the Irish Financial Regulator, seeking measurement against international comparators, commissioned the Mazars Report (2009) which recommended the creation of a new Directorate which would have overall responsibility for five areas including a dedicated enforcement team. Within the re-integrated regulatory structure established by the Central Bank Reform Act 2010, important moves were afoot, including the establishment in late 2010 of a dedicated Enforcement Directorate enlarging the Mazars approach. The Central Bank on the 21st December 2010 introduced the new, and its first, standalone Enforcement Strategy covering the period 2010-2011, while its existent 2005 Administrative Sanction Procedure would continue to be utilised.

The regulator's new plan is to align the enforcement and supervisory directorates in tandem (*a la* US SEC practice), and to target their enforcement resources in two ways:

- (a) Pre-defined Enforcement - 60 percent targeting - where cases taken will be focused on seven themes chosen by the regulator, based against priority areas identified by supervisory colleagues; and
- (b) Reactive Enforcement - 40 percent targeting as already highlighted - which entails taking decisive enforcement action where serious concerns arise from the regulator's supervisory work and other sources of information and events, both internal and external.

Re-iterating post-2005 practice, the 2010 Strategy document proclaimed (2010:4-5): "Enforcement actions must have a deterrent effect and will engender confidence in the financial services regulatory regime".

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<sup>8</sup> COM (2010) 716 December, 2010 established the consultation process which ended in February, 2011. See Feedback Statement On Public Consultation On Commission Communication - Reinforcing Sanctioning Regimes In The Financial Sector, May 2011, available at [http://ec.europa.eu/internal\\_market/consultations/docs/2010/sanctions/feedback\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2010/sanctions/feedback_en.pdf)

## **The EU evolving patchwork**

EU criminal law, un-codified and absent a discrete EU criminal law concept, is an evolving, hybrid, multi-layered patchwork of legislation and case law from both national and European jurisdictions (Klip, 2009). Conway (2007) has explained that cooperation in criminal matters (which was decreed by the European Court of Justice (ECJ) in the Pupino<sup>9</sup> decision and is known as the enforcement obligation where Member States must take all measures necessary to guarantee the application and effectiveness of EU law (Tridimas, 2006) developed as an offshoot from a primary concern with economic freedom of trade and the free movement of economic actors.

For Klip (2009) the EU is no longer a purely economic entity where citizens have rights, since the Lisbon Treaty 2007 coupled with ECJ rulings effectively created one single institutional framework merging the internal market and the criminal law including applicable EU enforcement mechanisms. Whilst norms are formulated at EU level both implementation and enforcement take place at national level. However, in two major decisions between the EU Commission and the Council, dating from 2005 and 2007<sup>10</sup>, the EU Commission itself has now had implied direct powers recognised by ECJ ruling where ‘serious crimes’ are involved, a formula taken up by the EU Commission<sup>11</sup>.

Legislatively, the EU may by way of Directive establish minimum rules concerning the definition of criminal offences and sanctions regarding serious cross-border crime including inter alia money laundering, corruption, counterfeiting, and computer and organised crime<sup>12</sup>. In addition, other crimes may be added to the list including those affecting financial services. ‘Serious crime’ in the EU context generally refers to offences attracting a sanction stipulation of imprisonment for five or more years.

Resulting from a cross-sectoral stocktaking review of member state financial regulatory enforcement practices, in December, 2010 the EU Commission (SEC, 2010, 1496 final: 11-14) identified serious shortcomings in such EU sanctioning and in particular six divergences and weaknesses in national sanctioning regimes:

- (a) Some competent authorities lack important types of sanctioning powers for certain violations;

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<sup>9</sup> Pupino (2005): Case C-105/03 criminal proceedings against Maria Pupino [2005] ECR I-5285

<sup>10</sup> Case C-176/03 Commission v Council [2005] ECR I-7879; Case C-440/05 Commission v Council [2007] ECR I-9097

<sup>11</sup> The view that regulatory offences should only have a criminal dimension where ‘serious’ was proposed in the UK also (and thus influenced Ireland) by the Macrory Review, Regulatory Justice: Making Sanctions Effective, Final Report, November 2006, Professor Richard B. Macrory, and legislated in part 3 of the UK Regulatory Enforcement and Sanctions Act 2008

<sup>12</sup> Klip (2009: 157-158); art 83 (1) TFEU and art 69B.1 inserted into TEU by Art 2.67 Lisbon Treaty



- (b) The levels of administrative pecuniary sanctions (fines) vary widely and are too low in some;
- (c) Some competent authorities cannot address administrative sanctions to both natural and legal persons;
- (d) Competent authorities do not take into account the same criteria in sanction application;
- (e) Divergence exists in the nature (administrative or criminal) of sanctions provided;
- (f) The level of application of sanctions varies.

The paradigmatic financial crisis response however has led to calls for greater convergence reform of 'divergent and fragmented' transposition of EU legislation into national law with EU legislation itself establishing the necessary common minimum standards.

The EU Road to 'speedy and effective' financial regulation can more recently be traced from 2007 when the financial crisis began to bite. In December, 2007 the EU Council invited the EU Commission to conduct the cross-sectoral stock-taking exercise of Member State sanctioning powers and regimes, which resulted in the publication of the six identified shortcomings.

The post-crisis EU sponsored de Larosiere Report (2009) - which was purposed towards financial regulatory reforms - recommended the deployment of, "sanctioning regimes that are sufficiently convergent, strict, [and] resulting in deterrence". Effectuating solidarity these recommendations were approved by the Irish regulator in his annual report<sup>13</sup>. Hard on the heels of de Larosiere in March, 2009 the EU Commission published a Roadmap (COM, 2009/114) which specified that one of five key objectives was to ensure more effective sanctions against market wrongdoing.

In synchronised choreography, within two weeks the ECOFIN Council (COM, 2009/114: 3) called for better regulation of financial markets advocating "rigorous enforcement of financial regulation and transparency, backed by effective, proportionate and dissuasive sanctions, in order to promote integrity in financial markets".

In early December, 2010, the EU Commission, simultaneous to its announced conclusions from the 'cross-sectoral stocktaking exercise', identified sixteen key financial regulatory sanction actions (COM, 2010/716: 11-16) including inter alia, the following four:

- (1) Ensuring appropriate interplay between administrative and any criminal sanctions imposed ;
- (2) Levels of fines should exceed the potential financial benefits;
- (3) The EU Commission will assess (consultation process to aid) whether and in which areas the introduction of criminal sanctions

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<sup>13</sup> See Irish Financial Regulator 2008 Annual Report at p16 and de Larosiere Report p 13-37 for recommendations

- and the establishment of minimum rules on the definition of criminal offences and sanctions may prove to be essential;
- (4) Proposals in the field of criminal law must ensure appropriate ‘coherence and consistency across different sectors’.

The EU Commission (COM, 2010/716: 14) stressed that, “...criminal sanctions when appropriately applied, in particular imprisonment, send a strong message of disapproval”; and concluded by envisaging:

... an EU legislative initiative to promote convergence and reinforcement of national sanctioning regimes ... [because] these objectives cannot be sufficiently achieved by the Member States alone: in the absence of a common EU framework, national initiatives cannot ensure consistency in the reinforcement of sanctioning regimes ( COM, 2010/716: 11).

Simultaneously, in December 2010 the EU Commission Impact Assessment recommended<sup>14</sup>:

- (1) Introducing criminal sanctions for the most serious violations, on a par with Irish reform pronouncements;
- (2) Reinforcing mechanisms facilitating both detection of infringements and enforcement sanctions; and
- (3) Introducing minimum EU-wide common criteria addressing the type and level of administrative sanctions.

## **Conclusion**

Enforcement in the financial regulation control domain post crisis has been recognised in Ireland and at EU level as an essential reform pillar. This conclusion also resonates elsewhere such as the UK and US where regulatory reform agendas are actively pursued. This ‘reform-talk’ is against a backdrop of historical and other influences. A renewed call for greater involvement of the criminal dimension impacts the enforcement pyramid which is the prime enforcement framework. Within the EU regulatory space sanction convergence is essential for single market coherence. In Ireland controlling systemic banking risk is a top policy priority.

Irish and EU Financial Regulatory reforms, including the criminal dimension, mutually impacted by foreign influences, politics, economics, and the markets including corporate (banking) failure, coupled with the administrative versus criminal sanctioning tension, are drawing the financial regulatory paradigms closer in an effective commonality. This is shown by their use or reliance upon ECJ rulings which are central for both, for instance: (a) the Greek Maize ECJ ruling that the 3 principles “effective,

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<sup>14</sup> SEC (2010) The Impact Assessment Procedure is part of the EU Commission’s Better Regulation principles

proportionate, dissuasive” apply to sanctioning; (b) The two Commission v Council ECJ rulings that the EU Commission may act itself in relation to ‘serious’ crime; and (c) Pupino where in a member state setting the Treaty co-operation principle was applied to (EU) criminal law.

Further, both draw inspiration from the EU commissioned de Larosiere Report recommendation for “Clear rules and enforcement powers” and, for example, have recognised the powerful place of criminal sanctioning including imprisonment for serious offences and have thus re-aligned or re-emphasised (not shifted) the Responsive Regulation paradigm towards coercive deterrence.

Reflecting Scott’s (2010) broader constitutionalist approach to regulatory governance (which embraces non-state actors and mechanisms for governing that go beyond legal rules) both increasingly use the public consultation process in US ‘notice and comment’ style to identify and define enforcement elements within the financial regulatory ‘control domain’. Both also use the new criminal law conceptualisation economic rationale for deterrence ‘messaging’ or ‘pricing’ and in ‘targeting’ a hallmark of the risk-based regulatory approach adopted by the G20, the EU and Ireland. A new ‘mechanisms’ definition of financial regulation has emerged based around the concept of ‘risk’ where new special resolution regimes and vehicles have been established in both jurisdictions, and indeed beyond, exemplified in the UK by the Debt Management Office (DMO) and Asset Protection Agency (APA) as well as the ‘bespoke’ administrative apparatus to manage them (Black, 2010), and in the US by the Troubled Asset Relief Program (TARP).

But is this ‘reform-talk’ merely rhetoric, or to what extent will meaningful change occur? There is normally a narrow window of opportunity for reform and if attitudinal and legal changes are delayed, the latter a common feature of EU governance, then pre-crisis ‘softer touch’ enforcement may well persist. Clearly, industry favours a diluted form of criminal law involvement and political will towards meaningful reform must be closely monitored. Even if implemented, future criminal prosecution will likely centre on the more serious offences. Braithwaite (2010) himself, post crisis, has argued that white-collar crime is more under-deterred than other forms of crime, and suffered more under-investment in prevention and preventive policing. Perhaps his eminent opinion, added to the many others, will carry sufficient weight to establish the necessary reforms both legislatively and in practice.

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### **Cases**

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