IMF STAFF COMMENTS ON

EU COMMISSION STAFF CONSULTATION ON REINFORCING SANCTIONING REGIMES IN THE FINANCIAL SERVICES SECTOR

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Submission by:

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Please note that the views expressed in these comments are those of the IMF's staff, and not necessarily of its management or Executive Board.

Main points

- The Consultation Communication correctly identifies the gaps and weaknesses in the present sanctioning regimes in the EU including divergences in the design and enforcement of sanctions. It makes well the case for greater convergence of sanctioning regimes in the EU through the setting of minimum common standards.

- However, the proposals should go further to fully harmonize the sanctioning regimes and allow increased sanctioning powers by EU institutions. This would reduce the scope for arbitrage across national jurisdictions and enhance the effectiveness of the new EU supervisory architecture and future crisis management framework.

- The proposed EU legislative proposal should explicitly set out the broad range of enforcement powers and sanctions that includes: (i) a tougher set of penalties against both institutions and individuals including disgorgement of any gains from malfeasance in addition to fines and criminal liability; and (ii) full disclosure of the imposition of sanctions with only limited exceptions.

General considerations

1. **The Fund staff welcomes this opportunity to comment on this Consultation Communication of the Directorate General Internal Market and Services of the European Commission (EC).**[1] We fully support the initiative to coordinate and integrate national authorities' enforcement activities and to ensure that national authorities have at their disposal appropriate sanctioning powers. This initiative is timely and fits in well with the recent decision by the G20 to strengthen sanctioning regimes and is consistent with actions taken by other authorities of major financial systems.

2. **The impact assessment found marked differences in sanctioning regimes across EU countries.** There are divergences in: (i) the type of sanctions that are available to authorities; (ii) the maximum severity of sanctions available; and (iii) the enforcement of EU rules and the application of sanctions across Member States. These conclusions are consistent with the IMF's Financial Sector Assessment Program/Basel Core Principles assessments that indicate that remedial actions in the EU lack predictable consistency (even for cross-border institutions) and, in practice, enforcement of supervisory actions has been slow in many instances.

3. **Such a situation weakens the capacity of officials to ensure that earlier intervention takes place to safeguard assets and capital and also lessens the possibility for a satisfactory resolution to be in place in a timely manner**. The lack of enforcement of EU financial services rules in Member States may also undermine consumer protection and market integrity, and distort competition in the single market. It may also negatively impact the effectiveness of the new EU supervisory architecture in particular, regarding cross-border supervision.

4. **Moreover, among most countries in the EU, there appears to us to be a preference for non-public actions.** Indeed, several IMF assessments reference that formal measures are avoided in practice, with a preference for moral suasion and confidential supervision. In the broader context, the lack of enforcement of EU financial services rules in a Member State can have effects on financial stability beyond the domestic financial sector, as a result of large cross-border activities of EU banks.

5. The proposals set out in the Consultation Communication are good initial steps, but we have some comments on the proposed policy and some additional issues for consideration.

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[1] This contribution has been prepared by the staffs of the European Department, Legal Department, and the Monetary and Capital Markets Department of the IMF and has been approved by the Directors of these departments.

6. **In general, we fully support the view that action needs to be taken at the EU level and that the minimum core common standards of national sanctioning regimes should include:** (i) a core set of administrative sanctions available in all EU countries; (ii) a requirement to publish sanctions; (iii) minimum levels of fines; (iv) sanctions possible both for legal and natural persons; (v) enforcement and the criteria to be considered when applying sanctions, including, in addition to the seriousness of the violation, the financial benefits of the violation, the cooperative behavior of the violator, and duration of the violation; (vi) the possibility of criminal sanctions.

7. **We support the recommendation that the EU framework for improved sanctioning regimes is based on minimum core common standards.** Our concerns regarding maximum harmonization are that no individual Member State would be able to impose a higher or more stringent penalty and such an approach could unnecessarily politicize the process of agreeing on the list of malpractices and the associated sanctions. We also recommend that a broad range of enforcement measures including sanctions are included in future legislation with a focus on encouraging the timely use of such stronger powers and graduated enforcement of even more onerous measures when called for.

Specific Comments on the Proposals

Appropriate types of administrative sanctions for the violation of key provisions

8. In section 4.2, the proposal is that for violations of each key provision of an EU legislative act, a core set of administrative sanctions should be provided in all Member States. It is also intended that the sanctions should be of a nature as to allow the authorities to impose a sanction that is likely to be optimal in each case. We note that some examples of sanctions are cited but these are non-exhaustive. To strengthen the sanctions, we suggest that:

- The authorities be empowered to impose a wide range of administrative sanctions of varying severity.

- The broad range of available sanctions be explicitly spelt out in the future legislation to include, among others, withdrawal of licenses, disqualification/ dismissal of managers, warnings, administrative fines, restriction of licensed activities, prohibition of new activities, and public reprimands.

9. **Apart from standardizing the core set of administrative actions, we would also suggest that the EC works with the new European Supervisory Authorities on the degree of discretion to be given to national authorities in the application of the optimal sanction beyond the minimum levels.** When authorities are empowered with a wide range of administrative sanctions, guidance on the appropriate sanction is necessary to ensure consistency in the application and prevent regulatory arbitrage. The European Supervisory Authorities should be well placed to provide such guidance when they have sufficient independence and capacity in this area. The guidance could draw from the criteria to be taken

into account when applying sanctions (that is one of the proposals in the Consultation Communication) with a view to ensuring that similar considerations are taken into account when deciding on the appropriate sanction for the violation. This would also ensure consistency in the application of the proportionality principle, i.e. that the sanction that is imposed is proportionate to the gravity of the violation. Further, there should be some form of a review process to ensure that the authorities apply the guidance in a uniform manner.

Publication of sanctions

10. **We agree that publication of sanctions is important as it plays a deterrent and signaling effect.** We support the proposed approach to provide for a general obligation to publicly disclose a sanction with the specific exception being where the disclosure would seriously jeopardize the financial markets. We would suggest that the exception to the general obligation be worded broadly to provide the authorities with the flexibility to withhold publication or to publish in an anonymous manner, but only if and when the facts of the specific case warrant such a departure.

A sufficiently high level of administrative fines

11. **It is recognized that, in some cases, the gains that could be obtained from violations of financial services legislation could be much larger than the actual maximum fine that can be imposed.** The proposal is to set thresholds that are sufficiently high so as to ensure deterrence from all types of infringements. As the gains could potentially be very large, the minimum threshold may not always be easily ascertainable and applied consistently across Member States.

12. **An alternative to setting a specific threshold would be to peg the fine to the benefit derived or loss avoided as a result of the violation of the legislation** (e.g. as a multiple of the quantum), akin to the practices of some Member States in the context of insider dealing. It is however recognized that the actual benefit derived or loss avoided may not always be easily ascertainable and hence, a hybrid approach comprising of either a computation tied to the benefit derived or loss avoided and a specific minimum threshold could be an alternative. Alternatively, guidance can be obtained from other legal principles for assessing damages e.g. causation principles involving direct or consequential losses in tort law.

13. **We would also suggest that, in certain cases, there be a regime for the benefits to be disgorged by the violator or any third party who has received such benefits.** Such a disgorgement regime would ensure that the violator or a third party would not be able to reap the benefits of the violation, which may be much higher than the fine that can be imposed. The basis for such a disgorgement is restitution and this would be a separate tool from any criminal prosecution that could also be taken. Where the third party has altered his position such that it would not be equitable for him to disgorge the benefits and where he is not aware

that the benefits were the result of a violation, then it may not be equitable for such a third party to give back the benefits. A related issue would be the availability of the benefits which could be disgorged. In this regard, we would suggest a parallel regime that allows the authorities to freeze the assets of a violator or to apply to Court to do so, in order to preserve the ability of the violator to give back the profits of the violation.

Sanctions provided for both individuals and financial institutions

14. W**e believe that sanctions should apply against both the institution and individuals.** It is proposed that sanctions should be imposed on the individuals responsible for a violation and/or on the relevant financial institution. However, it is also stated that where the individual person responsible acted to the benefit of a financial institution, fining the financial institution may be more appropriate. We are of the view that in many cases, it is likely that a case can be made out that the individual acted to the benefit of the financial institution. However, the benefit of the financial institution may not always be aligned with compliance with the relevant legislation. As such, in addition to the financial institution also being liable for the violation, we would suggest that individuals be held personally liable if they fail to take reasonable steps to secure compliance with the relevant legislation.

Appropriate criteria to be taken into account when applying sanctions

15. **One of the proposed factors to be taken into account relate to the financial strength of the author of the violation**, as indicated by elements such as the annual turnover of a financial institution. Would such a discriminatory approach towards applying sanctions violate any fundamental principles such as the right to be treated equally? Conversely, would the inability of an author to pay the penalty result in such an author being let off with a smaller penalty?

16. **In addition to the factors to be taken into account that are set out in the Consultation, some possible other factors include:**

- Whether any person (e.g. the general public) suffered any loss or was aggrieved as a result of the infringement by the author and whether in general there was a negative impact on the financial systems, markets, and depositors.

- Whether the infringement was self-reported (this could be a subset of the consideration as to the cooperative behavior of the author of the violation).

- Whether there have been past violations, whether of a similar legislation or otherwise, by the same author, i.e. the compliance record of the author.

- Whether the violation is ongoing.

- The degree of intent.

- The conduct of the author after the violation e.g. whether any remedial actions have been taken to ensure that the violation will not be repeated.

Possible introduction of criminal sanctions for the most serious violations

17. **We agree that criminal sanctions may be appropriate in certain cases, but also wonder if there may be important caveats in the area of the criminal infringements that need to be borne in mind in improving the sanctioning regimes.** It is possible that the gateways for cooperation between the relevant competent authorities may need to be reviewed if cooperation is needed in respect of a criminal action. The Consultation suggests that the establishment of the new European Supervisory Authorities will facilitate national cooperation – a reasonable assumption especially for civil matters – but there may be sensitivities in relation to criminal proceedings that may need more care or more work.

18. **As imprisonment can only be imposed against natural persons and not on corporate entities, there may be less deterrent effect against corporations that can afford to pay the penalty.** Apart from the proposal to also punish individuals responsible for corporate violations, one option is to provide for a "doubling-up" of the penalty when the author is a corporate entity. In lieu of imprisonment, the corporate entity could be fined up to double the maximum penalty provided for under the legislation.

Other Issues

19. **In addition to the issues raised above, we would like to raise the following additional issues for further consideration** (these were not covered in the Consultation Communication):

- Whether there is a regime for composition of criminal offences in the Member States and if so, the need to harmonize the framework for offences which are compounded in lieu of prosecution. Harmonizing the framework would prevent the problems raised in paragraph 3.2 of the Consultation Communication, in particular, regulatory arbitrage and ensure a consistent treatment of offences of a similar nature within the EU.

- Whether there is a regime for administrative settlements involving fines and penalties in the Member States and if so, the need to harmonize the framework for administrative settlements, for the same reasons set out in the bullet point immediately above.

- As also discussed above in relation to disgorgement, whether there should be a parallel regime that allows authorities to freeze assets of a violator or to apply to Court to do so, in order to preserve the ability of the violator to pay the penalty of the violation.