

Credible Deterrence and Consumer Protection through the Imposition of Financial Penalties: Lessons for the Financial Conduct Authority

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Abstract:

Protecting the consumer is one of the principal objectives of financial regulation. One of the main ways by which regulators seek to achieve that protection is by deterring harmful conduct by firms. In this essay, Peter Cartwright examines deterrence in theory and practice, assessing the FCA's championing of "credible deterrence", and considering the extent to which such an approach is, and should be, used by the regulator.

Introduction

One of the main objectives of Financial Regulation is to protect the consumer.¹ It is widely assumed that without some intervention from the state, consumers will be liable to suffer detriment. Debate therefore tends to focus on the ways in which such protection might best be secured, rather than whether intervention is necessary at all.

The purpose of this essay is to examine the role of what has been labelled 'credible deterrence' in financial regulation. The essay focuses, in particular, on the use of financial penalties to protect consumers from misconduct by firms. Such examination is especially topical for a number of reasons. First, the UK's principal conduct regulator, the Financial Conduct Authority (FCA), has committed itself to the policy of credible deterrence championed by its predecessor, the Financial Services Authority (FSA).² Second, this is taking place against a background of increasing interest in the part that

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¹ See e.g. G. Benston, 'Consumer Protection as Justification for Regulating Financial-Services Firms and Products', *Journal of Financial Services Research* 17(3), 2000, 277; P. Cartwright, *Banks Consumers and Regulation*, Oxford: Hart, 2004; P. Cartwright, *Consumer Protection in Financial Services*, Dordrecht: Kluwer Law International, 1999; Consumers International, *In Search of Good Practices in Financial Consumer Protection*, February 2013; D. Llewellyn, *The Economic Rationale for Financial Regulation*, London: FSA, April 1999); N. Moloney, *How to Protect Investors*, Cambridge: Cambridge University Press, 2010; World Bank, *Good Practices for Financial Consumer Protection* (June 2012).

² In the words of the FCA's Director of Enforcement and Financial Crime 'the FCA is just as committed to achieving credible deterrence as the FSA was.' Tracey McDermott, "Enforcement and Credible Deterrence in the FCA" Thompson Reuters Compliance and Risk Summit, London, 18 June 2013

penalties (broadly understood) should play in regulatory regimes.³ Third, the Parliamentary Commission on Banking Standards has set out extremely important proposals to enable trust to be restored in banking.⁴ Some of these proposals concern how to improve standards through sanctioning. The essay begins by examining the concept of deterrence in theory, before considering the FCA's approach to ensuring credible deterrence by the imposition of financial penalties. It then identifies several concerns with credible deterrence, both in theory and in practice. Next, the essay considers how these concerns might be addressed. Finally, conclusions are drawn.

Part One: Deterrence

Deterrence in Theory

The academic work on deterrence frequently focuses on deterrence by the imposition of sanctions, particularly in the form of penalties imposed by the criminal law.⁵ However, deterrence also features prominently as an objective of administrative monetary penalties (hereafter "financial penalties") such as those imposed under the Financial Services and Markets Act 2000 (FSMA) regime.⁶ It is often assumed that the actual or threatened imposition of sanctions (including financial penalties) can deter wrongdoing. This assumption applies both to individuals and to firms. For example, Wells argues that: '[m]ost corporate crime theory has been deterrent-based, in the sense that the purpose of instituting sanctions has been to discourage violations and encourage good practice'.⁷ Deterrence may be specific, where the focus is on deterring a particular person (firm or individual) from future wrongdoing, or general, which concerns deterring others from engaging in similar conduct. In both cases the assumption is made that the imposition (or potential imposition) of a penalty incentivises compliance through the threat it makes. Both forms of deterrence are mentioned in the FCA's Decision Procedure and Penalties Manual (DEPP).⁸

³ See in particular R. Macrory, *Regulatory Justice: Sanctioning in a post-Hampton World*, London: Cabinet Office, 2006.

⁴ Parliamentary Commission on Banking Standards *Changing Banking for Good*, London: Stationery Office, HC 27-1, HC 175-1 June 2013.

⁵ See e.g. G. Becker, 'Crime and Punishment: an Economic Approach', *Journal of Political Economy*, 76, 1968, 169; C. Wells, *Corporations and Criminal Responsibility*, 2nd ed, Oxford: Oxford University Press, 2001. The FCA, like its predecessor can prosecute for a variety of criminal offences but doing so is rare. In 2012-13 the Authority concluded just four trials, which resulted in 13 criminal convictions. 12 of these were for insider dealing and one was related to unauthorised business. See FSA, *Enforcement Annual Performance Account 2012-2013*, p. 5. The FCA's approach to prosecution is set out in *the Enforcement Guide* chap 12.

⁶ See generally FCA, *Decision Procedures and Penalties Manual* (DEPP) p 6 and FCA, *The Enforcement Guide* chap 7.

⁷ Wells op. cit, p 31.

⁸ Op. cit para 6.1.2.

One question for a financial regulator is how it should use the enforcement tools it has at its disposal.⁹ Financial regulators, like others with enforcement functions, can adopt different enforcement strategies based on their objectives. One of these has been labelled a 'deterrence' or 'sanctioning' strategy. The aim of such a strategy has been said to be:

'to secure conformity with the law by detecting violation, determining who is responsible for the violation, and penalising violations to deter violations in the future, either by those who are punished or by those who might do so were violations not penalised.'¹⁰

Individuals and firms could both be the subject of such an approach. However, it has been argued that firms may be more likely than individuals to make rational decisions aimed at maximizing financial gain. According to Ramsay:¹¹

'while criminals generally do not carefully calculate the probable consequences of their actions and therefore are often not deterred by the threat of punishment, this cannot be said of the corporate criminal. Since corporate activity is normally undertaken in order to reap some economic benefit, corporate decision makers choose courses of action based on a calculation of potential costs and benefits.'

Gobert and Punch suggest similarly that companies may be 'the prime example of the rational cost benefit calculators which those who champion deterrence theory had in mind.'¹² Economic models have been developed to try to establish when to take formal enforcement action and what penalty to seek or impose, based on assumptions about probable behaviour.¹³ The extent to which these models reflect the behaviour of firms depends in part on the motivation and character of the firm in question. Kagan and Scholz divide firms into different categories such as political citizens, amoral calculators and the organisationally incompetent.¹⁴ Amoral calculators are those who are 'motivated entirely by profit-seeking' and who 'carefully and competently assess opportunities and

⁹ The question of what sort of tools the regulator should have is an important one but beyond the scope of this essay.

¹⁰ A.J. Reiss, 'Selecting Strategies of Social Control Over Organisational Life', in K. Hawkins and J. Thomas (eds) *Enforcing Regulation*, Boston: Kluwer Nijhoff, 1984, pp. 23-24.

¹¹ I. Ramsay, 'Developments in the Law: Corporate Crime', (1978-79) *92 Harvard Law Review* 92, 1978-79, 1227, p. 1231

¹² J. Gobert and M. Punch, *Rethinking Corporate Crime*, London: Lexis Nexis, 2003, p. 219.

¹³ Most famous is Becker op. cit. It should be noted that some penalties are within the power of the regulator whereas others will rest with external institutions such as the courts.

¹⁴ R. Kagan and J. Scholz 'The "Criminology of the Corporation" and Regulatory Enforcement Strategies' in Hawkins and Thomas op.cit, p. 67.

risks'.¹⁵ These are akin to the rational cost benefit calculators envisaged by Gobert and Punch. For these firms in particular, it could be argued that regulators should focus on pursuing deterrence.

Characterisation of firms as falling within a particular category can therefore inform regulators' responses to their conduct. An amoral calculator will in theory be deterred from breaking the law if a cost-benefit analysis suggests that it is better to comply than to contravene. To use a simplified model, it will comply with the law where $pD > U$. This is where p is the perceived likelihood of having the contravention identified and a penalty imposed, D is the perceived level of detriment that results from the contravention, and U is the perceived benefit from contravention.¹⁶ On this basis, the principal factors that deter contravention are the probability of enforcement action (as perceived by the firm) and the level of detriment that it perceives will result. From the perspective of a regulator, it is far cheaper for the level of penalty (which forms part of D) to be raised than for the intensity of enforcement action (which forms part of p) to be raised. Whether the regulator has similar control over these variables will depend on a range of factors. For example, where the criminal law is concerned, any penalty will be imposed by the criminal courts rather than the regulator itself and so largely beyond the latter's control.

Deterrence strategies might be championed on the assumption that (some) firms will engage in a cost benefit analysis of whether to contravene or comply. By demonstrating a willingness to take formal action, for example through the imposition of penalties, the regulator is making a clear statement to the firm in question, as well as to others, that it will not tolerate contravention. It is clear that there is strong support at the FCA for focusing on deterrence.

Credible Deterrence and Enforcement at the FCA

The FCA sees what it calls 'credible deterrence' as a central element in its approach to enforcement. In *The FCA's Approach to Advancing its Objectives* the Authority defined credible deterrence as follows:¹⁷

'this is the strategy behind FCA enforcement that we use to deter firms and individuals from operating in a way that can harm the industry or consumers, by making it clear that there are real and meaningful consequences for those who

¹⁵ Ibid p. 67.

¹⁶ See Becker op. cit and A, Ogus. *Regulation: Legal Form and Economic Theory*, Oxford, Oxford University Press, 1994, chap. 5.

¹⁷ FCA, *The FCA's Approach to Advancing its Objectives*, London: FCA, July 2013, p. 48.

breach our principles or rules. It includes sanctions such as civil action, criminal prosecution, fines, prohibitions, and publishing details of misconduct on our website.'

The FSA had also placed significant emphasis on credible deterrence some years before it was replaced by the FCA. For example, in 2009, the FSA's then Director of Enforcement championed credible deterrence, saying that it was about making people 'sit up and pay attention.'¹⁸ Furthermore, when summarising the FSA's approach to its enforcement function in its final year of operation, Tracey McDermott (now the FCA's Director of Enforcement and Financial Crime) stated that the FSA's approach 'has been to achieve credible deterrence regarding our Financial Services and Markets Act (FSMA) mandate.'¹⁹ More recently, she has emphasised that 'the FCA is just as committed to achieving credible deterrence as the FSA was.'²⁰ If anything, the FCA appears to be placing even greater emphasis on credible deterrence as part of its enforcement and disciplinary strategy.

Financial Penalties and the FCA

As is made clear in the extract above, FCA has a range of powers that might deter misconduct. They include prohibitions and public censure as well as the financial penalties that are the principal focus of this piece. In exercising its power to issue a financial penalty, the FCA must have regard to the relevant provisions in the FCA Handbook, and to guidance published in the Handbook and set out in the Regulatory Guides, in particular DEPP. DEPP provides that the principal purpose of imposing a financial penalty is to:

'promote high standards of regulatory and/or market conduct by deterring persons who have committed breaches from committing further breaches, helping to deter other persons from committing similar breaches, and demonstrating generally the benefits of compliant behaviour.'²¹

It is clear, therefore, that the FCA sees the imposition of a financial penalty as central to achieving its policy of credible deterrence. However, it is also possible to identify significant concerns with the use of financial penalties to achieve such deterrence, both in theory and in practice. These are now considered.

¹⁸ M. Cole, 'Delivering Credible Deterrence', FSA Annual Crime Conference 27th April 2009.

¹⁹ FSA *Enforcement Annual Performance Account* op.cit, p. 5.

²⁰ McDermott, op.cit.

²¹ DEPP 6.1.2 G.

Part Two: Some Concerns with Credible Deterrence in Theory and Practice

Credible deterrence lies at the heart of the FCA's enforcement strategy. It is perhaps understandable that regulators should wish to project an image of themselves as fearless enforcers. This is particularly the case for those organisations that have been criticised for alleged laxity of supervision and enforcement. The FSA, for example, was avowedly 'light touch' but was claimed by some critics to be 'soft touch'.²² Against the background of a global financial crisis and widespread concern about financial misconduct, it is to be expected that a financial regulator would wish to demonstrate its authority. It is also clear that the Regulator accepts the essential premise of deterrence outlined above. In the words of Tracey McDermott 'To achieve credible deterrence, wrongdoers must not only realise that they face a real and tangible risk of being held to account, but must also expect to face a meaningful sanctions.'²³ However, this focus on credible deterrence raises a number of significant concerns.

Types of Firm and (Dis)Proportionality

While theories of optimal deterrence are based primarily on a vision of firms as amoral calculators, many firms will not adopt a cost-benefit analysis of the type envisaged. Firms comply with the law for a host of reasons other than the fear of receiving a sanction. These reasons include a sense of duty and habit, and also a respect for the rule of law.²⁴ Ayres and Braithwaite have commented that a majority of firms will comply with the law most of the time 'because it is the law.'²⁵ The reluctance of many regulators to take enforcement action as a matter of course is based in part on the assumption that most firms are motivated to comply and that most contraventions are not calculated.²⁶ The optimal deterrence model outlined above is therefore of limited utility where a firm is not inclined deliberately to flout the law. In practice, many contraventions occur where firms act without due skill and care rather than on the basis of conscious decision-making, and it is arguably difficult to deter negligence. Many breaches of FSMA occur where firms lack inadequate controls, supervision and organisation rather than where they display wilful misconduct.

²² 'Days of soft-touch regulation are over, says FSA chairman', interview with Adair Turner, *The Guardian* 16 October 2008.

²³ FSA *Enforcement Annual Performance Account* op.cit.

²⁴ See for example I. Ayres and J. Braithwaite *Responsive Regulation: Transcending the Deregulation Debate* New York: Oxford University Press, 1992; N. Gunningham, R. Kagan and R. Thornton, 'General Deterrence and Corporate Behaviour' *Law and Policy* 27, 2005, 262.

²⁵ Ayres and Braithwaite, *ibid* p. 19. Note also C Sunstein *Free Markets and Social Justice* New York: Oxford University Press, 1997, chap. two.

²⁶ See below.

Where breaches result from inadvertence rather than anything more sinister, there are questions about whether a focus on deterrence is appropriate. There are two principal objections: first that a focus on deterrence in such circumstances is ineffective (and even counterproductive) and second that it is unfair (which may, in turn, lead to it being even less effective).

In terms of effectiveness, it has been noted that the logic underpinning optimal deterrence is lost where firms are not making decisions whether to comply. Some recent empirical research questions the extent to which punitive approaches to regulation are effective in encouraging compliance on the part of typical firms. Baldwin comments as follows:

'Corporations...will often be confused and irrational about punitive risks; their staff may conflate individual and corporate liabilities; they may be poorly organised to deal with, anticipate or react to punitive risks and the effects of sanctions; their Boards may under-perform in supervising or providing leadership on punitive risk management and they may be poorly placed to assess how they and their staff are performing as risk managers.'²⁷

This raises a number of issues about the relationship between compliance, deterrence and risk management. In part, it reflects the idea that many firms may best be classed as organisationally incompetent – inclined to obey the law but potentially fallible. Thinking in terms of optimal (or credible) deterrence does not fit easily with the organisationally incompetent firm. The firm is not choosing to transgress, and so it cannot easily be deterred from so doing. Indeed, it is possible to go further and say that a deterrence strategy is not only liable to be ineffective in securing compliance where such firms are concerned, but may be counterproductive. One reason for this is that the over-zealous use of enforcement may make firms less inclined to co-operate with regulators. Shapiro and Rabinowitz argue that 'if the government punishes companies in circumstances where managers believe that there has been good faith compliance, corporate officers may react by being less co-operative with regulatory agencies.'²⁸ Ayres and Braithwaite provide additional support for this view, suggesting that focusing heavily on formal enforcement is liable to foster 'an organised business subculture of resistance to regulation'.²⁹ Similar views have been expressed by commentators in a number of

²⁷ R. Baldwin, 'The New Punitive Regulation', *Modern Law Review* 67(3), 2004, 351 p. 369.

²⁸ S. Shapiro and R. Rabinowitz, 'Punishment versus Co-operation in Regulatory Enforcement: a Case Study of OSHA', *Administrative Law Review* 14, 1997, 714 p. 718.

²⁹ Ayres and Braithwaite *op. cit.* p. 20.

different areas.³⁰ Adopting punishment as a first-choice strategy may be seen as 'unaffordable, unworkable, and counter-productive in undermining the good will of those with a commitment to compliance.'³¹ In addition, it risks the loss of socially useful activity as firms may choose to exit the market in question.

The second objection to a focus on deterrence for firms who lack the intent to contravene is that such a focus is simply unfair, regardless of any impact it might have. There is a danger of penalties being formally imposed which do not reflect the culpability of the firm. Even where the formal sanction is a financial penalty, part of the 'sting' of the sanction may be the negative publicity that results from its imposition. The danger of disproportionality is particularly apparent in such circumstances, given that the impact of adverse publicity is determined not formally by the regulator or the courts, but instead by what has been described as the 'capricious jury of public opinion'.³² Where the consequences of particular enforcement action are excessive, that action will presumably (and perhaps inevitably) be disproportionate. Some commentators have argued that while regulators should take account of proportionality: 'the most that is required to satisfy the principle of proportionality is formal proportionate quantification of sentence in advance, irrespective of the degree of impact upon an offender.'³³ This seems questionable. If it is anticipated by the regulator that particular action is likely to have a disproportionate impact on a particular firm, it seems difficult to argue that the enforcer has met its duty to act in a proportionate manner.

Effectiveness of Deterrence where firms are amoral calculators

A second concern is that, to the extent that there are rational firms adopting a cost-benefit analysis, it is doubtful that such firms will be deterred by the actions of regulators, whether that action be prosecution and the subsequent imposition of a (criminal) fine, or the imposition of a (civil) financial penalty. Most of the research in this area focuses on the use of the criminal rather than civil law. Some such research has emphasised that the likelihood of firms' being pursued and penalised is very small. Looking at regulatory offences generally, Ogus estimates that criminal prosecutions account for no more than 0.05% of reported contraventions.³⁴ There are various

³⁰ See E. Bardach and R. Kagan *Going by the Book: the Problem of Regulatory Unreasonableness*, Philadelphia: Temple University Press, 1982; G. Richardson, A. Ogus and P. Burroughs, *Policing Pollution*, Oxford: Clarendon Press, 1982 p. 126 and R. Cranston, *Regulating Business: Law and Consumer Agencies*, London: Macmillan, 1979.

³¹ Ayres and Braithwaite op. cit p. 26.

³² B. Fisse and J. Braithwaite, *The Impact of Publicity on Corporate Offenders*, Albany: State University of New York Press, 1983, p.310

³³ Ibid, p. 310.

³⁴ A. Ogus 'Better Regulation-Better Enforcement', in S. Weatherill (ed) *Better Regulation*, Oxford: Hart, 2007, p. 111.

reasons for this, but one (emphasised by Macrory in *Regulatory Justice*) is the resource-intensive nature of prosecution.³⁵ Not only is the probability of apprehension and formal action such as prosecution low, but it is also likely that firms realise this to be the case.³⁶ As a result, the value of p is likely to be low. By the same token, where penalties are imposed, the level of those penalties is typically low (and probably realised to be so). For example, Macrory quotes the average fine imposed for prosecutions brought by the Environment Agency in 2005 as being just over £5000.³⁷ In its major report *Changing Banking for Good* the Parliamentary Commission on Banking Standards argued that where the FSA's actions against banks were concerned 'the credibility of enforcement has been damaged by a legacy of fines that were pitiful compared to the benefits banks gained from the misconduct'.³⁸ While D does not consist only of the level of formal penalty but also other forms of detriment (such as the inconvenience of dealing with enforcement action, any negative publicity arising from such action and so on) it is doubtful that this will be perceived as sufficiently significant to amount to a credible deterrent. On this basis a rational firm may conclude that the benefits of contravention (U) outweigh the costs. The need to ensure that penalties are sufficient to deter is considered below.

It could be argued that where criminal (rather than civil) financial penalties are concerned there is an added weight to the penalty because of the stigma attached to the criminal label. Indeed, it has been suggested that business people 'abhor' the label of criminality.³⁹ But this can be over-stated. First, regulatory offences will often be treated as 'not criminal in any real sense', both by defendants and by the public.⁴⁰ This implies that even where members of the public (for example, consumers) realise that an offence has been committed, they do not attribute significant stigma to the wrongdoer. Second, it is doubtful that the public in practice distinguishes between whether the penalty was criminal or civil. The word 'penalty' is neutral in this regard and even 'fine' can be used to encompass criminal and civil financial penalties. Whether a criminal penalty is more likely than a civil sanction to be given publicity (for example by the regulator) is unclear.

The issue of proportionality is also relevant where amoral calculators are concerned. There may be an argument for imposing a penalty whenever there is intentional

³⁵ Macrory op. cit. para 2.2.

³⁶ Although not necessarily. See L. A. Bechuk and L. Kaplow, 'Optimal sanctions when individuals are imperfectly informed about the probability of apprehension' *Journal of Legal Studies* 21 1992, 365.

³⁷ Macrory op. cit table 2.1.

³⁸ Op. cit para 231.

³⁹ H. Ball and L. Friedman 'Use of Criminal Sanctions in the Enforcement of Economic Legislation: a Sociological View', *Stanford Law Review* 17, 1965, 197 pp. 216-217

⁴⁰ A phrase from *Sherras v De Rutzen* [1895] 1 Q.B. 918 at 922.

wrongdoing. However, for that penalty credibly to deter the amoral calculator, it might have to be so high that it seems disproportionate to the wrongdoing. Indeed, there is a danger of what has been labelled the 'deterrence trap' where to be an effective deterrent, a penalty may be so high as to put a firm out of business, a result which will frequently not be justified.⁴¹ The balance between providing a penalty that is likely to deter, and ensuring that any such penalty is not disproportionate to the wrongdoing, is frequently difficult to find.

A further point to consider is that where the process involved does not involve all the safeguards associated with a criminal trial, it may be more likely that mistakes are made.⁴² Despite the undoubted safeguards provided in the area of financial services, this remains a concern.

Consequentialism

Finally, the focus on deterrence suggests that imposing penalties is primarily consequentialist.⁴³ The FCA appears to assume that positive consequences can be achieved by imposing penalties and that this justifies their imposition. This is illustrated, at least to some extent, by some of the principles which underpin the FCA's approach to its enforcement powers. In particular, principle four states that:⁴⁴

'The FCA will aim to change the behaviour of the person who is the subject of its action, to deter future non-compliance by others, to eliminate any financial gain or benefit from non-compliance, and where appropriate, to remedy the harm caused by non-compliance.'

This wording may be familiar to some readers. It reflects the Penalties Principles set out by Macrory in *Regulatory Justice*.⁴⁵ Tracey McDermott, in commenting on the FSA's enforcement in its last year of operation said: '[w]e have focused on cases where we think we can make a real difference to consumers and markets, using enforcement strategically as a tool to change behaviour in the financial services industry.'⁴⁶ It is understandable that a regulator would wish to focus on consequences. The public expects regulators to achieve results and a focus on this will typically be desirable. However, it would be concerning if that were the only driver. There are strong

⁴¹ Although perhaps not always. See *R v Cotswold Geotechnical Holdings* [2011] EWCA Crim. 1337.

⁴² Ogus 'Better Regulation' op. cit p 110.

⁴³ The term 'consequentialist' is used quite loosely here to reflect an approach which aims primarily to achieve a particular objective such as a change in behaviour.

⁴⁴ *FCA Enforcement Guide* op. cit para 2.2.

⁴⁵ Macrory op. cit.

⁴⁶ *FSA Enforcement Annual Performance Account* op.cit.

arguments that imposing penalties can also have a symbolic role in demonstrating censure and that they should be based, at least in part, on the idea of deserts. This may be particularly true of penalties imposed under the criminal law, but might also be true of other penalties. While DEPP does make reference to matters that might be described as non-consequentialist or retributive, the focus and balance appears consequentialist, and the tone of credible deterrence certainly is.⁴⁷ The more serious the wrongdoing, the more important it is that sanctions reflect that seriousness, regardless of (or perhaps in addition to) any aim of achieving deterrence.⁴⁸ Seriousness is made up of two principal elements: the extent and/or type of harm, and the degree of culpability.⁴⁹ A sanctioning regime, be it criminal or civil, needs to be willing to impose penalties that reflect that seriousness, even in circumstances where it cannot be assumed it will change conduct in the future.

Part Three: Addressing the Concerns

This section looks at how we might address the concerns raised by a focus on credible deterrence. It considers how deterrence might be made more effective; how different types of firm might be treated; how proportionality can be achieved, and how sanctioning needs to reflect concepts that might be described as non-consequentialist. It will become clear that in practice, the FCA does look beyond credible deterrence and address a number of these issues, despite its apparent focus on the concept.

Effectiveness

The first issue to consider is the concern that deterrence is unlikely to be effective (and therefore credible) even for amoral calculators. This might be addressed in a number of ways.

Increasing the Value of p

First, for deterrence strategies to work firms must believe that there is a realistic prospect of their being pursued, investigated and sanctioned for wrongdoing. To a large extent this depends in the approach the regulator takes to supervision and, in particular, to trying to identify breaches. The FCA's approach is risk-based, and resources are

⁴⁷ See below.

⁴⁸ Retributive theories which focus on punishment as a morally appropriate response to wrongdoing incorporate the need for punishment to be consequentialist in the sense of also deterring crime. See A Ashworth 'Sentencing' in M. Maguire, R. Morgan and R Reiner *The Oxford Handbook of Criminology* 2nd ed., Oxford: Oxford University Press, 1997, pp. 1096-1097.

⁴⁹ Culpability will typically be concerned with *mens rea* but will sometimes be broadened to include attitude and motivation. See for example the Crime and Disorder Act 1998.

deployed on the basis of perceived threats to its regulatory objectives. In relation to its overall approach to supervision, the FCA states:⁵⁰

'The FCA will adopt a pre-emptive approach which will be based on making forward-looking judgments about firms' business models, product strategy and how they run their businesses, to enable the FCA to identify and intervene earlier to prevent problems crystallising.'

In addition, the FCA has stated that its supervision model is *inter alia*: 'forward looking and more interventionist...consumer-centric...robust when things go wrong...[and] viewing poor behaviour in all markets through the lens of impact on consumers.'⁵¹ This suggests a qualitatively different attitude to supervision from that taken by its predecessor. Coupled with the focus the FCA has said it places on firms (and sectors) that could cause, or are causing, harm to consumers or that threaten market integrity, it is plausible to argue that in future firms will believe it more likely that wrongdoing will be identified and responded to. There is strong support for a greater focus on enforcement action in *Changing Banking for Good*. The Report argues that:⁵²

'Greater priority needs to be placed on the role of enforcement, with adequate resources devoted to this function and leadership with a willingness to pursue even the difficult cases, often involving the larger and more powerful players, in order to build up a credible deterrent effect.'

In terms of whether the response of the FCA involves a financial penalty, the factors that the organisation will consider when deciding whether to take action for a financial penalty are set out in DEPP, although the FCA recognizes that the list is not exhaustive and that some will not be applicable in specific cases.⁵³ The factors are: the nature, seriousness and impact of the suspected breach; the conduct of the person after the breach; the previous disciplinary record and compliance history of the person; FCA guidance and other published materials; action taken by the FSA or FCA in previous similar cases; and action taken by other domestic or international regulatory authorities.⁵⁴ This demonstrates that a decision to impose a penalty is a matter of judgement to be taken on the basis of a range of criteria. As will be seen later, it also calls into doubt the centrality of deterrence to decision making.

⁵⁰ SUP 1A 3.1.

⁵¹ SUP 1A 3.2.G

⁵² Op. cit vol 1 para 247

⁵³ DEPP 6.2.1. The same factors apply to public censure.

⁵⁴ DEPP 6.2.1 (G).

The FSA had previously recognized the need to demonstrate more clearly a willingness to take action if deterrence was to be made more credible. One possible concern is that the FSA imposed fewer fines (as it referred to them) in 2012-13 (51) than it had in either of the previous two financial years.⁵⁵ So the focus on credible deterrence had not led to a greater number of fines being imposed. Despite this reduction, the FCA has stated that its approach to meeting the consumer protection objective through credible deterrence is to be achieved in part by bringing more enforcement cases.⁵⁶ Where this is communicated effectively to those who might consider contravention, it raises the value of p in the model above. While it is true that firms may still not have an accurate picture of the value of p , this is not fatal to the success of deterrence. Indeed, it has been noted that for general deterrence to succeed, what matters is the *perception* of the risk of action being taken.⁵⁷ Ogus, for example, suggests that 'if traders generally perceive the value of p to be significantly higher than in reality is the case, there is no reason to disturb this impression if it can contribute to a higher level of compliance.'⁵⁸ In practice, it seems unlikely that well-informed firms will consider it more likely that they will face action unless there is in fact an increase.

Increasing the Value of D

Second, for deterrence to be credible there is a need to demonstrate that where contravention is established, meaningful detriment is likely to follow. The most obvious component of D is the penalty imposed as a result of contravention.

DEPP sets out some of the factors to be taken into account when determining the level of penalty that is appropriate and proportionate to the misconduct. The regime for penalty-setting is based upon three principles: disgorgement; discipline and deterrence.

Disgorgement means that a firm (or individual) should not benefit from the breach, discipline means that they should be penalised for any wrongdoing, and deterrence means that any penalty imposed 'should deter the firm or individual who committed the breach, and others, from committing further or similar breaches.'⁵⁹

It is difficult to assess whether the penalties imposed upon firms are sufficient to contribute towards credible deterrence. As noted above, this seems doubtful where firms

⁵⁵ There were also fewer prohibitions than in previous years. See *FSA Enforcement Annual Performance Account* op.cit.

⁵⁶ *FCA The FCA's Approach to Advancing its Objectives* op. cit p 19.

⁵⁷ S Simpson *Corporate Crime and Social Control* Cambridge: Cambridge University Press, 2002, especially chap. 2.

⁵⁸ Ogus 'Better Regulation' op. cit p 113.

⁵⁹ DEPP 6.5.3 G.

are amoral calculators. However, there is some evidence of a recent willingness to increase financial penalties. The FSA imposed £423.2 million in financial penalties during the year 2012-13.⁶⁰ Subject to the points made about proportionality, there is a strong argument for penalties to be high. Despite the limitations of the economic approach to sanctioning set out above, it seems reasonable to argue that for those firms who either take a conscious decision to engage, or who risk engaging, in wrongdoing, higher penalties are more likely to deter than lower ones. There remain doubts about whether the financial penalties currently imposed fulfil this, and the question of whether the figures are skewed by action concerning LIBOR is important, but the FCA should receive some credit for the advances that appear to have been made.⁶¹ Furthermore, the FCA has also explained that it proposes to use credible deterrence to achieve its consumer protection objective in part by bringing more enforcement cases and pressing for tough penalties for infringements of rules so it is likely that this will continue.⁶² Indeed *Changing Banking for Good* argued that both the FCA and the PRA should further review again their penalty setting framework 'to allow for a further substantial increase in fines'.⁶³

Perhaps the clearest example of a move towards the imposition of higher financial penalties is the £28 million fine imposed by the FCA upon Lloyds Banking Group (specifically Lloyds TSB Bank plc and Bank of Scotland plc) in December 2013 for serious failings in their controls over sales incentive schemes.⁶⁴ It is the largest ever fine imposed by the FCA or FSA, for failings in retail conduct of business. The FCA investigated advised sales of investment and protection products between 1 January 2010 and 31 March 2012. It found that the firms had 'higher risk features in their advisers' financial incentive schemes which were not properly controlled'.⁶⁵ This provided a significant risk that advisers would sell products to customers that they neither needed nor wanted in order to maintain or increase their salaries. Over the period in question, the firms sold £2.25bn of investment products and received £118m in protection insurance premiums. Although they agreed to settle at an early stage (and so qualified for a 20 per cent discount) the FCA increased the fine by 10 per cent because of

⁶⁰ In 2011-12 it was just 76.4m. See *FSA Enforcement Annual Performance Account* op.cit.

⁶¹ *Changing Banking for Good* described the precedent set by the fines imposed in relation to LIBOR as 'encouraging', op. cit para 231.

⁶² *FCA The FCA's Approach to Advancing its Objectives* op. cit p 19.

⁶³ Op cit para 231.

⁶⁴ 'FCA fines Lloyds Banking Group firms a total of £28,038,800 for serious sales incentive failings' (FCA/PN/109/2013).

⁶⁵ *Ibid.*

previous warnings about the use of poorly managed incentive schemes and the firms' previous disciplinary record.⁶⁶

Refocusing D

Discussion of deterrence strategies frequently takes place in the context of wrongdoing by firms and most of the discussion above has assumed that the recipient of a financial penalty will be a firm. It is notable that the FSA began to focus greater attention on individuals and the FCA has taken this forward. In 2013-13, the FSA took more actions against individuals than against firms, imposing over £5 million in fines.⁶⁷

This attention on individual liability is extremely important. Action against individuals will sometimes be more appropriate than that against firms. While recognizing that the primary responsibility for ensuring compliance with a firm's regulatory obligations is that of the firm, DEPP states that the FCA may take disciplinary action against an 'approved person' where there is evidence of personal culpability on his or her part. It continues by saying that 'Personal culpability arises where the behaviour was deliberate or where the approved person's standard of behaviour was below that which would be reasonable in all the circumstances at the time of the conduct concerned.'⁶⁸

There has been increasing emphasis on the role of personal liability as a deterrent against wrongdoing by firms.⁶⁹ There is concern that a focus on the firm as a legal person raises particular difficulties. First, it is sometimes difficult to attach culpability to a business. This is particularly so where the criminal law is concerned, because of the nature of corporate criminal liability (where it is notoriously difficult to attach liability for offences requiring proof of *mens rea*, and may also be problematic where strict liability offences are accompanied by defences of due diligence).⁷⁰ Fault (broadly understood) may exist within companies in different ways and at different levels. This has been starkly revealed where the criminal law is invoked against often large and complex firms. Attempts have been made to capture wrongdoing for the purposes of attributing fault,

⁶⁶ Lloyds TSB Bank plc had been fined in 2003 for the unsuitable sale of bonds which had been caused in part because of inappropriate incentives.

⁶⁷ FSA *Enforcement Annual Performance Account* op.cit.

⁶⁸ DEPP 6.2.4 (G).

⁶⁹ Particularly in the context of corporate crime. See ; B. Fisse and J. Braithwaite, *Corporations, Crime and Accountability*, Cambridge: Cambridge University Press, 1993, pp. 158-162; Gobert and Punch op. cit chap 8; Wells op. cit.p 160-163.

⁷⁰ See e.g. P. Cartwright, *Consumer Protection and the Criminal Law*, Cambridge: Cambridge University Press, 2001, chap. 4; Wells *ibid*; Fisse and Braithwaite *ibid*.

but it remains difficult.⁷¹ Second, as noted above, it is questionable whether a financial penalty against a firm is likely to have the same deterrent effect as a penalty against an individual. The former may be treated as little more than a business expense, whereas (depending on the precise penalty) the latter may lead not only to the individual losing his or her livelihood, but potentially their freedom where the criminal law is invoked. Where penalties are administrative rather than criminal, incarceration is not an issue, but loss of livelihood remains so.

The FCA recognises that individuals will sometimes need to be targeted by a policy based on deterrence. In particular, the FCA has announced its determination to pursue senior managers who, in its words, fail to: 'recognise and manage the risk that their firm is running; control the way their products are sold; [and] ensure that the interests of consumers are at the heart of those designing new products.'⁷² This has been reinforced by the FCA's subsequent statements. In June 2013 Tracey McDermott said that 'repeated fines for conduct failures here and overseas demonstrates that fining firms alone is not enough' and that 'we must do something different. In order to achieve credible deterrence, senior managers must be held to account.'⁷³ It is submitted that the FCA is rightly concerned with individual fault. Fault is broader than the traditional criminal law concept of subjective *mens rea*, the latter incorporating concepts such as intention recklessness and dishonesty. As noted above, fault includes where the approved person's standard of behaviour was below that which would be reasonable in all the circumstances. This form of objective fault is important as it demonstrates that individuals must give thought to how their conduct will be viewed objectively. Individuals who fail to do that face personal consequences.

It has long been accepted that individuals working within firms should take some responsibility for the actions of those firms. In the criminal law, this has largely taken the form of what might be called 'senior officer' provisions. Where an offence is committed with the consent or connivance of, or is attributable to any neglect on the part of, such a senior officer, he, as well as the company, is guilty of the offence. While consent and connivance imply knowledge of circumstances, the reference to neglect makes it clear that there is an objective element to such a provision. The focus on individual liability adopted by the FCA is to be welcomed. Indeed, the push for increased emphasis on individual responsibility has come from *Changing Banking for Good*. The

⁷¹ Possible models are considered in J. Gobert, 'Corporate Criminality: Four Models of Fault' *Legal Studies*, 1994, 14, 393 and R. Sullivan 'The Attribution of Culpability to Limited Companies' *Cambridge Law Journal* 56, 1996, 515.

⁷² FCA, *The FCA's Approach to Advancing its Objectives* op. cit p. 20.

⁷³ McDermott, op. cit p. 5.

Report makes a number of recommendations which would place greater and clearer responsibilities on individuals and, arguably, contribute to more effective deterrence. Among these is the suggestion that a 'Senior Persons Regime' replace the Approved Persons Regime in respect of banks. Under this, all the 'key responsibilities' within a bank would be assigned to a specific and senior individual.⁷⁴ This, it is suggested, would facilitate the identification of those most responsible for failures and make it easier to use enforcement powers against individuals. The Report also makes the case for legislation that would enable the regulators (both the FCA and PRA) to impose a wide range of civil sanctions (including a ban) on an individual 'unless that person can demonstrate that he or she took all reasonable steps to prevent or mitigate the effects of a specified failing.'⁷⁵ This would apply where two conditions are present: first, the individual's bank has been subject to enforcement action that has either been settled or upheld by the Tribunal; and second, that the regulator can show that the individual held specific responsibilities under the Senior Persons Regime which were directly relevant to the enforcement action in question.⁷⁶ This is a bold approach and one that cannot be investigated fully here. It echoes a due diligence defence in criminal law, where the defendant will be guilty unless he or she can demonstrate an absence of fault. However, it involves civil liability. Furthermore, the Report also recommends the creation of a new criminal offence of reckless misconduct in the management of a bank. Covering only those who are subject to the proposed Senior Persons Regime, the Report sees the offence as providing credible deterrence. In its words: 'the fact that recklessness in carrying out professional responsibilities carries a risk of a criminal conviction and a prison sentence would give pause for thought to the senior officers of UK banks.'⁷⁷ Substantial fines can already be imposed as a civil penalty, with the advantage of a lower standard of proof. However, the proposed offence could provide more compelling deterrence, partly through the stigma attached to conviction but more significantly through the possibility of imprisonment.

Rethinking D

It has been noted above that D represents the detriment from contravention and so includes more than just the formal penalty. As D represents the cost to the defendant, it may include disruption, inconvenience and the cost of complying with the requirements of a regulator *post* wrongdoing. Baldwin has emphasised that 'penal effects may extend very considerably beyond the level of any fine imposed', suggesting that formal enforcement action may adversely affect reputation, cause operational disturbances and

⁷⁴ Op cit para 98.

⁷⁵ Ibid para 240

⁷⁶ Ibid.

⁷⁷ Para 243.

managerial disruptions, worsen relationships between regulator and regulated and adversely affect investor relations.⁷⁸ Similarly, Ogus recognises that costs from contravention include:⁷⁹

‘the hassle and personal inconvenience arising from encounters with the victims of regulatory contraventions and with public officials, legal and other defence expenditures, as well as any loss of market reputation resulting from the contravention being detected.’

One element of D which is particularly important is the negative publicity that may arise from the contravention.⁸⁰ Where there has been breach of the criminal law, and this is well-publicised, it may have a chilling effect on the defendant. Firms pay close attention to their image, and the label of criminal conviction may have a significant adverse effect upon this. As Ball and Friedman argue: ‘the word “crime” has symbolic meaning for the public and the criminal law is stained so deeply with notions of morality and immorality, public censure and punishment, that labelling an act as criminal often has consequences that go far beyond mere administrative effectiveness’. They conclude that ‘businessmen abhor the idea of being branded a criminal’, and that fear of prosecution is an effective deterrent to business people.⁸¹ While it is submitted that the stigma that attaches to prosecution and conviction (particularly in the regulatory sphere) is often overstated, there is little doubt that firms which value their public image will be concerned at having the label of criminality attached to them.

Negative publicity does not only arise from breach of the criminal law. Indeed, as noted above, it is doubtful that the public distinguishes clearly between criminal sanctions and civil financial penalties. As a consequence, the well-publicised imposition of a civil penalty is likely to lead at least to some adverse publicity. Of course, to the extent that the public does not make this distinction concerns may arise. If the word ‘crime’; does have symbolic meaning for the public, it is a matter of concern if the public treats non-criminal penalties as carrying the same stigma as criminal penalties.

⁷⁸ Baldwin op.cit p. 351

⁷⁹ Ogus ‘Better Regulation’ op. cit p. 109.

⁸⁰ See P. Cartwright, ‘Publicity, punishment and protection: the role(s) of adverse publicity in consumer policy’, *Legal Studies* 32(3), 2012, 179; K. Yeung, ‘Is the Use of Informal Adverse Publicity a Legitimate Regulatory Compliance Technique?’ Australian Institute of Criminology Conference, Melbourne, 3 September 2002. The problems with informal publicity are also examined by Fisse and Braithwaite *The Impact of Publicity on Corporate Offenders* op. cit chap. 20; F. Rourke, ‘Law Enforcement Through Publicity’, *University of Chicago Law Review*, 24, 1956-57, 225; A.A. Curcio, ‘Painful Publicity – an Alternative Punitive Damage Sanction’ *DePaul Law Review*, 45, 1995-96, 341, p.380.

⁸¹ Ball and Friedman op. cit pp. 216- 217.

Furthermore, the FSA has well-developed sanctions that take advantage of the power of negative publicity. As well as being able to impose financial penalties (which may themselves generate publicity) the FSA is able to impose public censure as an alternative to such penalties.⁸² The FSA's Guidance sets out the factors to be considered when deciding whether to impose public censure rather than a financial penalty. For example, the first factor is whether deterrence can be achieved effectively through a public censure. A second factor is whether the person has profited from, or avoided a loss from, the breach. A third factor is seriousness, with financial penalties (generally) being used in more serious cases. Fourth is that where the breach has been brought to the attention of the FSA by the person in question, it may make public censure more appropriate. Fifth, where the person admits the breach, fully co-operates with the FSA and takes steps to ensure that those who lose out receive compensation, again this may weigh in favour of merely public censure. Sixth, a poor disciplinary/compliance record is likely to point in favour of a financial penalty. The rationale for this is stated to be deterrence. Seventh, the FSA will look to ensure consistency in its approach, by considering previous cases. Finally, the FSA will consider the impact upon the person concerned. The factors reveal that public censure alone will typically be used in less serious cases, which may appear surprising given that negative publicity will in some cases provide a more compelling deterrent than the imposition of a financial penalty.⁸³

It should also be noted that negative publicity can arise without the imposition of a sanction, but merely through the conveying of negative information. This is particularly apparent in the area of the publication of complaints data. The FCA requires firms to publish certain details and then publishes aggregate and firm-level data.⁸⁴ The Financial Ombudsman Service (FOS) also publishes data about the complaints with which it deals. While these would not, typically, be described as sanctions, still less penalties, they may have a chastening effect upon firms and therefore be viewed through the lens of deterrence.

From U to D: Removing the Benefits of Contravention

The FCA's penalty-setting regime is based on a number of principles, the first of which is disgorgement. This echoes one of Macrory's 'Penalties Principles' in reflecting the idea that a firm or individual should not benefit from any breach.⁸⁵ This is fundamental to the success of a penalties regime in instrumental terms, but also reflects the principle that

⁸² Public censure includes a statement published under section 205 and a statement of misconduct published under section 66 of FSMA.

⁸³ Cartwright, 'Publicity, punishment and protection' op. cit p. 189.

⁸⁴ See <http://www.fca.org.uk/firms/systems-reporting/complaints-data>. Accessed 14-1-14.

⁸⁵ See <http://www.financial-ombudsman.org.uk/publications/complaints-data.html> Accessed 14-1-14.

no-one should benefit from their wrongdoing. The model of optimal deterrence identifies the benefit from contravention as U. If U can be reduced or eliminated this improves deterrence, as well as potentially providing redress for consumers.

There has been increasing interest in finding more creative ways of achieving this.⁸⁶ Consumer Redress Schemes are a particularly interesting topic for study in their own right. It is beyond the scope of this article to consider these in detail, but it is interesting to illustrate the role of the FCA in obtaining redress and its relationship with deterrence by referring to a recent development. In late 2013 the FCA reached an agreement with Card Protection Policy Ltd (CPP) and 13 high street banks and credit card issuers to pay redress to up to 7 million consumers who were the victims of misselling.⁸⁷ CPP had already been fined £10.5m in November 2012 for failing to treat customers fairly. While some consumers had been sold the products directly by CPP others were introduced via the banks and credit card issuers. If approved by its creditors (a majority the consumers in question who vote) and confirmed by the High Court, this scheme of arrangement could lead to very substantial redress being paid. It is notable that when arguing that the financial services industry should not be subject to reforms providing redress to consumer from unfair commercial practices, the Law Commission justified this on the basis that in the financial services sector 'there are already sophisticated mechanisms in place to protect consumers' and that redress often goes well beyond the types envisaged by the Law Commission.⁸⁸

It is important for the FCA to ensure that consumer redress is achieved effectively and the power to require firms to establish consumer redress schemes is an important part of that. But such schemes can also be seen from the perspective of deterrence. The threat of being able to impose such a scheme allows the FCA to negotiate solutions with firms. As seen in other areas, the possession of significant enforcement tools will often allow solutions to be negotiated without the need for formal action.⁸⁹ As the CPP example illustrates, it is possible to combine the imposition of a financial penalty with additional measures which have the effect of operating as a financial penalty, but which are characterised instead as redress. Where this occurs, the deterrent effect may be strong.

⁸⁶ One proposal from *Changing Banking for Good* (which is not considered in detail here) is that when a fine is imposed on a firm, a significant proportion of the fine should be met from deductions from the remuneration of the bank's staff at the time of the misconduct. The Report argues that this would provide a more direct incentive on individuals to prevent the misconduct. Op. cit para 230. This shows a link between removing benefits and deterrence.

⁸⁷ The power to require firms to operate a scheme exists under s.404 of FSMA.

⁸⁸ Law Commission, *Consumer Redress for Misleading and Aggressive Practices*, London: Law Commission, Cm 8323, March 2012.

⁸⁹ For example in the area of product safety. See also generally Ayres and Braithwaite *Responsive Regulation* op. cit.

Types of Firm and Proportionality

Considering Deterrence Where Intention is Lacking

It was noted above that the model of optimal deterrence works best for amoral calculators. It assumes that firms choose whether to engage in wrongdoing and need to be deterred from so doing. But many businesses will not be quite so calculating in practice. It is important to consider to what extent, if at all, credible deterrence plays a role for other firms.

The first point to note is that while the FCA has emphasised credible deterrence, it is clear that it takes a wide variety of factors into account when deciding whether, and how, to use its powers. A picture of this is provided by the FCA's *Enforcement Guide* which is produced to describe the FCA's approach to exercising its main enforcement powers. Four main principles underpin the FCA's approach to the use of its enforcement powers, the first three of which emphasise the need not to move immediately to formal enforcement. First, the FCA acknowledges that the effectiveness of the regime depends significantly upon 'maintaining an open and co-operative relationship between the FCA and those it regulates.' Second, the FCA states that it will seek to exercise its powers in a way that is 'transparent, proportionate, responsive to the issue and consistent with its publicly stated policies.' Third, the FCA states that it will 'seek to ensure fair treatment when exercising its enforcement powers.'⁹⁰

This reveals an interesting contrast with the rhetoric that has been heard of late from the FCA (and before that from the FSA) about credible deterrence. It has always been clear that the regulator is under a duty to use its powers proportionately and the Enforcement Guide helps to explain what that means. In practice, regulators are reluctant, and indeed unable, to pursue deterrence with the vigour that they sometimes imply. Optimal deterrence strategies of the type identified above are not representative of the approach of most regulators. The reality of regulatory enforcement is that regulators deploy possess, and deploy, a significant amount of bureaucratic discretion. In practice, what have been described as 'compliance strategies' are frequently utilised. A compliance strategy, sometimes referred to as 'advise and persuade' has as its aim 'to secure conformity with law by means of ensuring compliance or by taking action to prevent potential law violation without the necessity to detect, process and penalise violations.'⁹¹ In the words of Hawkins, 'its conception of enforcement centres upon the

⁹⁰ FCA, *Enforcement Guide* op. cit para 2.2.

⁹¹ Reiss op. cit p. 23.

attainment of the broad aims of legislation, rather than sanctioning its breach.⁹² As the FCA's comments above demonstrate, compliance-based approaches remain very much in evidence. Where there has been a contravention a judgement has to be made about the appropriate regulatory response.

The FCA makes the normative case for dealing with contravention without the need for formal discipline or other enforcement action. However, it does say that in such cases: 'the FCA will expect the firm to act promptly in taking the necessary remedial action with its supervisors to deal with the FCA's concerns' and that if the firm does not do this disciplinary or other enforcement action may follow.⁹³ It may be that the FCA's approach in large part reflects the 'tit for tat' enforcement strategy famously championed by Ayres and Braithwaite. Those authors argue that such an approach is characterised as follows:⁹⁴

'the regulator refrains from a deterrent response as long as the firm is co-operating; but when the firm yields to the temptation to exploit the co-operative posture of the regulator and cheats on compliance, then the regulator shifts from a cooperative to a deterrent response'.

Tit for tat places great emphasis on the attitude of the firm, something that the FCA recognises is important. Indeed, much has been said recently about culture, both in relation to the regulator and in relation to firms. If culture is, as has been suggested, 'the underpinning that drives the decisions we make and the actions we take' it may be reflected in the attitude of a firm to compliance.⁹⁵ Looked at this way, there might be a role for credible deterrence in deterring non-cooperative and incentivising cooperative behaviour.

A second major point to note is that there may be (some) culpability without intention. As noted above, a firm may have been reckless or careless, or simply devoted insufficient resources to supervision. Such conduct involves fault and can amount to a breach of many of the obligations owed by a firm. It could be argued that there remains a role for credible deterrence for contraventions based on carelessness or some other fault falling short of intention or dishonesty. Significant penalties have been imposed on

⁹² K Hawkins *Environment and Enforcement: Regulation and the Social Definition of Pollution*, Oxford: Clarendon Press, 1984, p. 4.

⁹³ FCA, *Enforcement Guide* op. cit para 2.4

⁹⁴ Ayres and Braithwaite, *Responsive Regulation* op cit p. 21

⁹⁵ McDermott, op. cit.

firms for such breaches.⁹⁶ The knowledge that a penalty is likely to be applied even for non-intentional contravention may have a role in encouraging high standards of supervision by firms and individuals. This is part of the justification for strict liability in the criminal law and may be particularly effective backed up by due diligence defences. A defendant who can demonstrate that despite committing the *actus reus* of an offence he has all taken reasonable precautions and exercising of all due diligence to avoid the offence will not be convicted. This incentivises firms and individuals to take care to avoid unintentional contravention.⁹⁷ This will (a) make commission of the *actus reus* less likely; and (b) help to ensure that, should it occur, a defence can be made out. Similarly, firms and individuals may face financial penalties for their failure to discharge their duties appropriately on the basis that this will deter such laxity. Credible deterrence may therefore have a role to play even in the absence of intention.

Consequentialist Focus

A final concern with the focus on deterrence is that the importance of non-consequentialist approaches might be lost. Since the 1960s at least there has been considerable scepticism about the extent to which consequentialist theories such as deterrence (and also rehabilitation) should form the basis for punishment, at least for individuals.⁹⁸ While some commentators continue to support such notions, focus has perhaps shifted towards the central role of punishment in reflecting wrongdoing. 'Just deserts' theories of punishment required not only that sentences should be determinate, but that they should be deserved. Wrongdoing is thought to deserve censure because it is wrong, and the censure should reflect that wrong. By focusing on potential results rather than actual wrongs, it could be argued that credible deterrence underplays this important role for sanctions. It should be noted that the FCA's regime does recognise, at least to some extent, the importance of non-consequentialist sanctioning. The second principle of the FSA's penalties regime is discipline – that a firm or individual should be penalised for wrongdoing. It seems though that this may have been lost in the incessant rhetoric of credible deterrence.

Conclusions

The FCA, like the FSA before it, has placed enormous emphasis on the role that pursuing a policy of credible deterrence can play in ensuring that the objectives of financial regulation are met. There is little doubt that some firms will be deterred from breaking

⁹⁶ For example, the FSA found that Bank of Scotland had caused significant harm to consumers because of poor mortgage records systems. This led to it fining the firm £4.2 million for its failures.

⁹⁷ The courts will frequently be influenced by the paper system that the defendant has in place. See *Tesco v Natrass* [1972] AC 153.

⁹⁸ See A. von Hirsch A. Ashworth and J. Roberts, *Principled Sentencing: Readings on Theory and Policy* 3rd ed, Oxford: Hart, 2009.

the law by the threat of sanctions such as financial penalties. However, deterrence may not be as great a driver of compliance as is sometimes assumed. Firms comply with the law for a host of reasons and where breaches occur, many are unintentional. Those firms which might be described as amoral calculators can be deterred in theory, but there are doubts as to how effectively they are deterred in practice. As in other sectors, formal enforcement action and the imposition of substantial penalties remains relatively unusual. Where such firms are concerned, deterrence might potentially be made more credible in a number of ways, including increasing the detriment that firms feel, increasing the probability of enforcement action, re-focusing the target of the enforcement action and removing the benefits from contravention. But improving deterrence in these ways may lead to claims of disproportionality on the part of the regulated. This, in turn, may sometimes reduce the effectiveness of regulation. It is important that regulators are responsive in their enforcement strategies, and where they do this, regulatory objectives are most likely to be met. The constraints that are placed upon the FCA's enforcement powers go some way towards ensuring that such responsiveness is embedded. This may mean that the rhetoric of credible deterrence is over-stated, but is a price worth paying.

