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Peter Guy
Co-Founder & Editor-At-Large
Regulation Asia

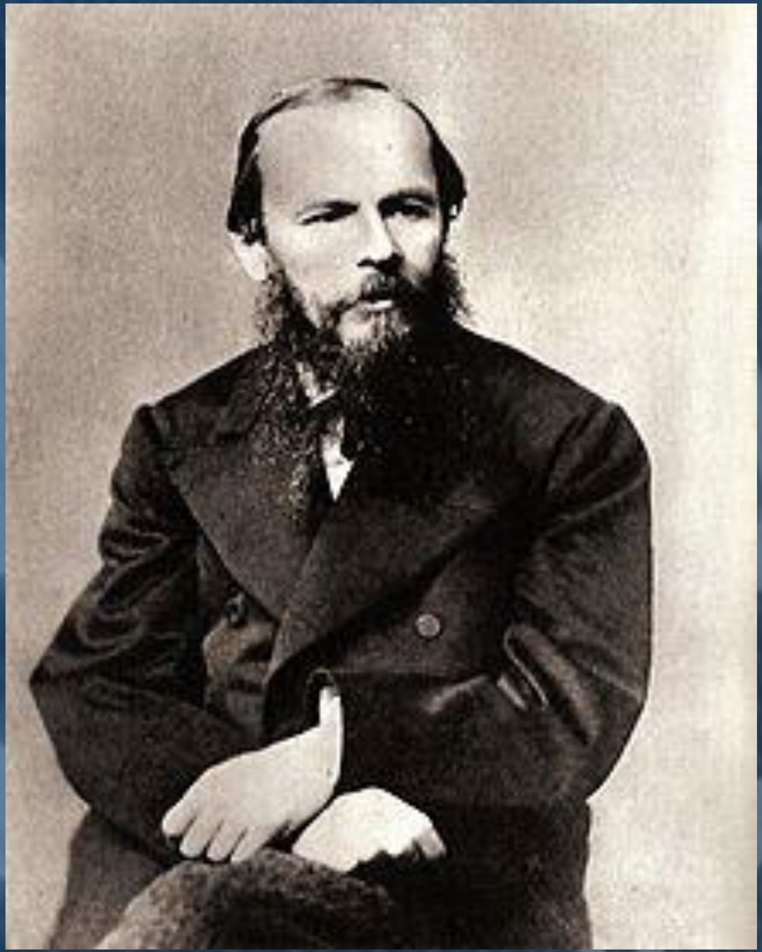
Misconduct, malfeasance: “Crime and Punishment?”

Presented by:
Peter Guy, Regulation Asia

The challenge: Can you regulate human nature and behaviour?

- Ongoing & renewed commitment by regulators, law enforcement, central banks around the world to connect and enforce securities, capital market and banking violations with **individual civil and criminal liability**.
- **Political pressure** over lack of criminal indictments and convictions over subprime mortgage back securities sales and trading continues to resonate and irritate.
- Don't forget **past prosecutions** for insider trading and fraud: Boesky, Levine, Enron.
- Regulators want law enforcement to **reach deeper** into the operations of financial institutions.
- Tough talk: "The Securities and Futures Commission will do whatever it takes to tackle misconduct." – Julia Leung, Hong Kong SFC
- Yet, according to Russian author Fyodor Dostoyevsky's "Crime and Punishment" people commit the same crimes for a reason.

Fyodor Dostoyevsky
author of “Crime and Punishment”



“What do you think, would not one tiny crime be wiped out by thousands of good deeds?”

— Fyodor Dostoevsky, Crime and Punishment

Going on offence: Australia Royal Commission

- On February 1st , Commissioner Kenneth Hayne submitted his final report on Australia's **Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry**.
- Thousands of submissions, testimonies and interviews found:
  - Charging fees for no service
  - Charging customers no longer alive
  - Reporting & disclosure breaches
  - Fraudulent documentation, cash bribes for loans
- Among **76 recommendations** are proposals for wide ranging conduct regulation, radical changes to how bankers are remunerated and incentivized.
- E.g. Mortgage brokers must act in the **best interest** of borrowers, not lenders. Borrowers to pay mortgage brokers instead of commissions from lenders

Kenneth Hayne, former Justice of Australia's High Court and head of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Hayne identified:

- Perverse connectivity between **conduct and rewards** skewing client outcomes
- Asymmetry of **power and information** between financial services entities and customers
- **Conflicts** between duty and personal interest
- Entities not being **held to account** for misconduct

Greed and folly lurk in the hearts of all bankers and traders

- Bankers, traders, sales – the best ones are "hard wired" to circumvent rules. Indeed, many innovative instruments, like subprime, CDS were designed to solve problems and most of all, make money.
- Credit default swap – unethical as it is like buying insurance for your neighbour's home and hoping that it burns down. Should not be buying or selling insurance where the counterparty has no insurable interest. Yet, this is not illegal.
- The worst victim AIG had to be saved by the US government. Yet the only way to save AIG was to save the CDS trades and all the counterparties involved. Smart or lucky trade?
- Trials, convictions of LIBOR traders show the difficulty of defining front running.
- Intense regulation may result in need for banking malpractice insurance like doctors.

Greed and folly lurk in the hearts of all bankers and traders

Another bubble is unavoidable due to human nature, jealously and greed.

"It is so contagious. So that's a permanent part of the system."

— Warren Buffet, in an CNBC interview reflecting on the week leading up to the 2007-2008 GFC.

"Culture and People. People and Culture."

- The problem is mainly attributed to corporate culture.
- If you provide **perverse incentives** and **reward bad behaviour** then expect misconduct to persist, become embedded in the judgment, conduct, practices of front line bankers.
- Money travels. Laws don't. In the case of **1MDB**, it appeared that those being charged didn't expect laws to travel to that corner of the world. But, this is an underlying premise of much misconduct and the **attitude of not getting caught**.
- Global banking culture change may require generational change – years after 2008. Today's financial industry leaders have served **half their careers** pre-financial crisis.
- The standard should be more than providing capital to pay fines – **"What's the number?"**
- Compliance and ethics should be core to making profits.

The 1MDB scandal is reaching boiling point

- Malaysia filed charges against Goldman and its former bankers, seeking $7.5bn in compensation
- Malaysia "will not compromise"; Goldman must "bear responsibility"
- Goldman cuts executive bonuses
- Deloitte, KPMG, PwC have all signed off on 1MDB audit reports
- Deloitte fined, plans to appeal

Quantitative study of market misconduct

- Predicting financial behavior using **quantitative methods** make for interesting observations and begins to draw useful inferences.
- Regulators have praise the study by the **FICC Markets Standards Board**: "**Misconduct Patterns in Financial Markets**"
- Behavioural Cluster Analysis identifies core behaviours which occur most frequently in **market misconduct** cases, emphasizes the importance of focusing on behavioural patterns as a vital point of reference.
- Report applies analysis to: price manipulation, circular trading, collusion & information sharing, inside information, reference price influence, improper order handling, misleading customers.
- This opens the way for "Reg Tech", AI, machine language, big data, deep data analysis to understand trading patterns.

Misconduct Patterns in Financial Markets
FICC Markets Standards Board


FICC MARKETS STANDARDS BOARD

MISCONDUCT PATTERNS IN FINANCIAL MARKETS

Selected Case Studies

July 2018

Seven broad categories of misconduct:

- price manipulation
- wash trading
- improper handling of client orders
- misleading customers
- manipulating reference prices
- trading on inside information
- collusion

The Future of Banking Culture and Compliance

- At a time when money is used to measure everything, can a compliance officer's suggestions make a difference? Need to **elevate compliance** to C-suite.
- **Conduct risk** has proven to be systemic and is not confined to asset class or jurisdictional boundaries.
- **Whistleblowing** is interpreted differently across cultures. Even Chinese attitudes are surprisingly different from other Asian countries.
- For example, **insider trading** remains difficult to enforce in Asia because so many Asians don't think it is wrong.
- We are seeing **bonus clawbacks** finally being used and the start of the enforcement of personal liability to business decisions. This will change the banking industry.
- No more "**too big to fail, too big to jail**."

Q&A

Peter Guy, Regulation Asia
peter@regulationasia.com

https://www.regulationasia.com