Chapter 2

Fraud, failure and financial crime

2.1 As part of an ongoing commitment to seek expert critiques in support of its oversight functions, the committee invited Dr George Gilligan as an expert witness to give evidence. Dr Gilligan is a senior research fellow in the Department of Business Law and Taxation at Monash University. He is a sociologist with research interests in regulation of the financial markets, white collar crime and organised crime.[1]

2.2 In his presentation to the committee Dr Gilligan covered four areas:

- the sociology of how regulations are understood and acted upon, including some history of the financial sector's status;
- the strategic importance of the contemporary financial sector and limits on its regulation;
- the nature of regulation and the competition of national regulatory regimes to attract capital; and
- financial crime.

2.3 These issues are closely interrelated. A major theme underpinning all four was balancing the promotion of markets and encouragement of entrepreneurialism with market protection and discouragement of crime and fraud.[2] As he told the committee:

> There is always this dilemma and this tension between promoting efficient, open and flexible markets to attract capital, to create wealth, to stimulate growth and to promote Australia as a global financial centre with competitive products in an international sense, but at the same time there is the context of protecting investors, and particularly the retail investors. It is always on that seesaw, that fulcrum, and there are always going to be people falling off who are going to get hurt.[3]

2.4 In view of its inquiry into the collapse of Trio Capital, the committee was particularly interested in the matter of fraud and financial crime and the degree to which regulations can minimise and expose misconduct. Dr Gilligan's explanation of the financial landscape gave a context for recommendations which would assist transparency and the identification of risk.

2.5 According to the OECD Policy Framework, which Dr Gilligan provided to the committee:

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1 http://users.monash.edu.au/~gilligan/ (accessed 6 January 2012)

2 Dr George Gilligan, *Committee Hansard*, 25 November 2011, pp 2, 5, 7, 8.

3 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 2.

> Financial system transparency is essential for [the development of sound policy and regulatory framework]...as it makes the operations of the system more visible and supports the identification of risks...and possible problems and needs.[4]

2.6 Dr Gilligan advised that, in the four core interrelated areas there are some significant breakdowns in such transparency, which he suggested may be addressed by ASIC.[5]

The social and historical context of financial regulation

2.7 The financial sector has a long history of self-regulation over centuries. This reflects the confluence of two trends: the defence of its independence (which has facilitated its growth in power), and the consequent dependence of rulers on the finance sector.[6] Originally, this was a dependence of the Crown for funding of military campaigns; in the contemporary context it is a dependence of governments on the sector for economic prosperity.

2.8 Dr Gilligan noted that because of this nexus, the financial industry was alone in being able to defy governments or ignore government regulation. He gave historical examples from the growth of the City of London of patterns of quite open defiance which set the context for contemporary assumptions within the financial sector.[7]

2.9 Dr Gilligan emphasised two important social ideas underpinning the operation of the financial sector. The first is the importance of trust:

> [T]he traditions of the financial services are a personal relationship...sociologies of trust that underpin the establishment of the markets are still core when people invest in markets. People still trust what they read about in a product disclosure statement. They still have that sense that, if there is a major institution or there are instruments and services that they are familiar with, they can somehow trust they will be there and that they will deliver as they are saying on paper.[8]

2.10 This point is evident from the testimonies of witnesses to the committee's inquiry into the collapse of Trio Capital.[9] Dr Gilligan pointed out that the habit of trust indicates a moral dimension which may be violated and gave instances from his

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4 OECD, *Policy Framework for Effective and Efficient Financial Regulation*, 2010, p. 10.

5 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 6.

6 Dr George Gilligan, *Committee Hansard*, 25 November 2011, pp 1–2, 6–7.

7 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 2.

8 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 2.

9 See particularly *Official Committee Hansard, Parliamentary Joint Committee on Corporations and Financial Services, Collapse of Trio capital, Thirroul*, 6 September 2011.

research on white collar crime.[10] Dr Gilligan noted that the Global Financial Crisis can be considered in terms of the abuse of sociologies of trust.[11]

2.11 The second idea is the concept of 'routinisation' or habit. Dr Gilligan explained that human agency interacts with social structures so that routines are perpetuated, regardless of their effectiveness.[12]

2.12 These two concepts—trust and routinisation—are central to Dr Gilligan's analysis of the interaction between financiers and government. Although modern financial organisations have responded to new regulatory structures,[13] they remain attached to past attitudes. For instance, he argued that those involved with the raising, organisation and marketing of capital have great influence in what is seen as the natural social and economic order. Whether consciously or not, they usually equate their own interests with the public interest. Dr Gilligan thereby claimed that regulation is used by the financial services sector to support the attitudes of self-regulation and autonomy inherited from the past.[14] According to Dr Gilligan, therefore, practices based on trust in the personal honour of the financial provider are reinforced.

2.13 Dr Gilligan applied the idea of routinisation to the definitions of financial crime. He suggested, for instance, that the classification of fraud is subject to long-standing habits and suggested that this could be an area for action by ASIC. In terms of distinguishing between fraud and market failure—an issue of interest to the committee—he argued that habits in categorisation make it difficult to define particular instances.[15]

Influence and control in the contemporary financial sector

2.14 Dr Gilligan presented various data indicating Australia's significant role in the global financial sector:

- The financial sector is the largest contributor to Australia's national output and is estimated to contribute 11 per cent or A$135 billion of Australia's Real

10 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 2.

11 Dr George Gilligan, Presentation to Joint Committee on Corporations and Financial Services, *Comments on some issues regarding financial services regulation in Australia*, 25 November 2011, p. 7, available at: http://www.aph.gov.au/senate/committee/corporations_ctte/asic/Additional_Information/Gilligan_Presentation_251111_ASIC_Oversight.pdf, (accessed 30 January 2012).

12 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 6.

13 Dr George Gilligan, *Expecting too much? Enforcement limitations in the regulation of financial markets*, Paper presented at ESRC/GOVNET Workshop, ANU, 14-15 March, 2007, p. 18.

14 Dr George Gilligan, *Expecting too much? Enforcement limitations in the regulation of financial markets*, Paper presented at ESRC/GOVNET Workshop, ANU, 14-15 March, 2007, p. 16–17.

15 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 4.

Gross Value Added by Industry in year to June 2011 (Australian Bureau of Statistics 2011).

- Almost 420,000 people are employed in Australia's finance sector (Australian Bureau of Statistics 2011).
- Australia is ranked 6th globally for good corporate governance by Governance Metrics International (2010).
- The Australian stock market was ranked in July 2011 as the 6th largest in the world at US$1,136 billion (Standard & Poor 2011).
- Australia's Funds Under Management at US$1,500 billion, ranked in 2011 as the 4th largest in the world (Investment Companies Institute 2011).
- Australia ranks 4th in the world in terms of superannuation (pension funds) assets at US$1,261 billion (Towers Watson 2011).
- Australia's financial markets turnover in 2009–2010 was almost A$102 trillion, more than 250 per cent higher than 1999–2000 (Austrade 2010).[16]

2.15 Dr Gilligan argued that with the rapid growth in financial market turnover, governments have needed to develop a more effective and efficient system of financial regulation.[17] Dr Gilligan notes that a key challenge in this regard has been to strike a balance between 'due process' versus 'crime control'. Too much focus on crime control could lead to 'flight of capital'; too much emphasis on due process could leave the market exposed to unscrupulous operators.[18] Dr Gilligan submitted that the right balance is a matter of judgment and negotiation between key stakeholders. The committee was told that regulatory enforcement is 'more art than science' and that the level of intervention is determined by what is judged as legitimate in the circumstances.[19]

2.16 Dr Gilligan told the committee that in terms of the 'due process crime control model', on a scale of 1 to 10:

> I imagine Australia would be sitting somewhere about 6 or 7. So it has an emphasis on efficient markets but also very substantive and largely

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16 Dr George Gilligan, Presentation to Joint Committee on Corporations and Financial Services, *Comments on some issues regarding financial services regulation in Australia*, 25 November 2011, pp 9–10, available at: http://www.aph.gov.au/senate/committee/corporations_ctte/asic/Additional_Information/Gilligan_Presentation_251111_ASIC_Oversight.pdf, (accessed 30 January 2012).

17 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 7.

18 Dr George Gilligan, *Committee Hansard*, 25 November 2011, pp 2, 5, 7.

19 Dr George Gilligan, *Expecting too much? Enforcement limitations in the regulation of financial markets*, Paper presented at ESRC/GOVNET Workshop, ANU, 14-15 March, 2007, pp 32–37; Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 1.

> effective, in my view, regulatory infrastructures to protect investors both retail and wholesale.[20]

2.17 He argued that the financial sector in Australia has 'an enormous amount of relative autonomy as we have seen through the global financial crisis' but also operates within a context of 'very substantive and largely effective regulatory infrastructures protect[ing] investors.'[21]

The 'beauty parade' of competition for capital

2.18 Dr Gilligan felt that most national regulators would follow the three core objectives defined by the International Organzition of Securities Commissions (IOSCO):

1. The protection of investors;
2. Ensuring that markets are fair, efficient and transparent; and
3. The reduction of systemic risk.[22]

2.19 The issue then becomes one of how well any national financial regime complies with IOSCO standards and how well it both encourages market innovation and also deters financial fraud or incompetence.

2.20 Dr Gilligan referred to the OECD *Policy Framework for Effective and Efficient Financial Regulation*, which gives five areas in which a regulator's effectiveness should be evaluated: the financial landscape, policy objectives, policy instruments, system design and implementation review.[23] According to Dr Gilligan, Australian regulators, including ASIC, do well on the OECD criteria. He noted that ASIC's reports have concentrated on deterrence and investigation issues, and have not given as much information about ASIC's activities in the 'educative-normative area'. Dr Gilligan felt that ASIC reports could better employ empirical data to show how ASIC's resources are allocated according to its six strategic priorities, and to emphasise the value of its educative activities. This would enable better publicity about its successes.[24]

2.21 Dr Gilligan also noted that, in his experience, the Australian regulatory system is well-regarded internationally.

> Every time I am at an international conference I note that the Australian regulatory actors are held in high regard not just because of their positions within IOSCO but also more generally because they are seen as proactive in

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20 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 7.

21 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 7.

22 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 3.

23 See http://www.oecd.org/dataoecd/28/49/44362818.pdf (accessed 10 February 2012).

24 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 3.

> developing regulatory models. They are seen as being balanced in the way that they seek to promote Australia as a financial sector yet still provide a context which provides reasonable—and, of course, that is a variable term but an important term—protection to the investors both wholesale and retail.[25]

2.22 In other words, Australia is well placed to continue to build its financial sector in the competitive market.

Committee view

2.23 The committee supports Dr Gilligan's commendation of ASIC and his assessment of the Commission's fine reputation internationally. The committee acknowledges Dr Gilligan's analysis of the importance of maintaining a balance between due process and crime control in order to enhance the Australian financial sector in a globally competitive market. In this context, the committee agrees that ASIC reports could better employ empirical data.

Recommendation 1

2.24 The committee recommends that ASIC acquire empirical evidence of its resource allocation to its educative activities and outcomes of these activities. This information should be more fully publicised in ASIC's regular reports and other media accessed by investors especially retail investors.

Financial crime

Problems of defining financial crime

2.25 Dr Gilligan's evidence considered the definition of financial crime in some detail. He noted that gaining empirical data on fraud and other financial crimes is greatly handicapped by a plethora of varied definitions with the result that meaningful statistics are hard to obtain:

> It is not just apples and oranges; it is apples, oranges, cherries, bananas and grapefruit—and that is just in an Australian context. It is not standardised across state courts or advisory councils, for example. I do not know whether this committee could somehow push that sort of line in a COAG type context to get greater standardisation of data recording and reporting.[26]

2.26 Dr Gilligan explained that different states aggregate data according to different criteria in apparently ad hoc ways. International jurisdictions also differ. The committee was presented with results of a survey Dr Gilligan had undertaken in which

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25 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 2.

26 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 3.

twenty one agencies in the United Kingdom and fourteen in Australia had responded to four questions about financial crime.[27]

2.27 Many of the agencies surveyed had no operational definition, and of those that did, there was no consistency. Dr Gilligan drew the conclusion that there was no shared approach or common definitions. There was inconsistent use of terminology and regular failure, even by police agencies, to have a working definition of financial crime.[28]

2.28 One outstanding example demonstrates this incoherence. The UK Financial Services Authority itself used the term 'financial crime' to cover 'fraud or dishonesty, misconduct or misuse of information relating to financial management or handling the proceeds of crime', even though identifying financial crime is one of its four statutory objectives.[29] Examples from the Australian agencies demonstrated similar inconsistencies and omissions.[30]

2.29 Dr Gilligan told the committee that:

> ... the lack of delineation, categorisation and classification...makes it difficult to say what the extent of the problem is. It is always more difficult to deal with a problem if you do not know the extent of the problem.[31]

2.30 He suggested that clarifying and systematically defining financial crime would be a worthy project for ASIC to pursue given that ASIC regulates across industrial sectors, has the resources and has access to relevant data.[32]

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27 These questions were: Does your agency use an operational definition of financial crime, and if so what is it?

What is the extent of financial crime in your jurisdiction?

If your agency does not use an operational definition of financial crime, what behaviours/offences that your agency seeks to counter could be categorised as financial crime?

If your agency does not use an operational definition of financial crime, what is the extent in your jurisdiction of the behaviours/offences that could be categorised as financial crime?

Dr George Gilligan, Presentation to Joint Committee on Corporations and Financial Services, *Comments on some issues regarding financial services regulation in Australia*, 25 November 2011, p. 24, available at: http://www.aph.gov.au/senate/committee/corporations_ctte/asic/Additional_Information/Gilligan_Presentation_251111_ASIC_Oversight.pdf, (accessed 30 January 2012).

28 Dr George Gilligan, *Committee Hansard*, 25 November 2011, pp 4–5.

29 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 4.

30 Dr George Gilligan, Presentation to Joint Committee on Corporations and Financial Services, *Comments on some issues regarding financial services regulation in Australia*, 25 November 2011, pp 27–29, available at: http://www.aph.gov.au/senate/committee/corporations_ctte/asic/Additional_Information/Gilligan_Presentation_251111_ASIC_Oversight.pdf, (accessed 30 January 2012).

31 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 4.

Fraud and failure

2.31 The committee's discussions focussed on the distinction between fraud as a criminal activity and failure of the market. In terms of fraud, Dr Gilligan claimed that there are some instances that are unquestionably fraudulent because of people's clear criminal activity. These cases require a higher level regulatory response. Beyond this, he felt that the main priority is to uniformly classify activities associated with fraud across Australian jurisdictions so that it can be identified, tabulated and addressed.[33]

2.32 On the question of market failure, Dr Gilligan focused attention on what level of harm can be considered acceptable before intervention should occur. The nexus between financial services and the national economy is of importance in making such judgments.[34]

2.33 Dr Gilligan did not feel that offering risky investments to unsophisticated investors could be described as a crime. He introduced the idea of abuse as an alternative way of thinking about them. He did stress that the greater the depth of empirical data on such matters, the greater the reliability of judgements made as to appropriate sanctions. Moreover, he suggested that collection of valid empirical data on outcomes of educative programs on financial product awareness would facilitate effective allocation of resources to help inform potential buyers of financial products. Better informed clients would be less susceptible to such abuse. [35]

Committee view

2.34 The committee is particularly interested in the matter of defining and dealing with financial crime and determining clear and consistent guidelines as to whether activities are fraudulent. It would also encourage further efforts to quantify the extent of criminal activity and acknowledges the difficulty of doing this when terminology is fluid and categories are variable. Here, the committee believes that there is an important role for ASIC in developing standard definitions and classifications that could be proposed for use across the Commonwealth.

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32 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 5.

33 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 6.

34 Dr George Gilligan, *Committee Hansard*, 25 November 2011, pp 6–7.

35 Dr George Gilligan, *Committee Hansard*, 25 November 2011, p. 8. Also compare p. 1

Recommendation 2

2.35 The committee recommends that ASIC take steps to use available information to collate and analyse definitions of, and approaches to, financial crime, with a view to developing standard definitions and classifications that can be used across the Commonwealth.

Recommendation 3

2.36 The committee further recommends that ASIC give particular attention to ways of distinguishing between criminal fraud and market failure, and the interventions available to ASIC in each case.