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THE FINANCIAL CRISIS: THE ROLE OF LAW AND REGULATION

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Introduction

It is a very great honour indeed to have followed in the footsteps of so many distinguished lecturers, and in particular those of yours, Chancellor[1], in being invited to give this lecture this evening. If Lord Merlyn-Rees had been alive at this time, given his long interest in economics and his tenure as Home Secretary from 1976 to 1979, I have no doubt that he would have many strong views on the subject matter of this lecture.

Being neither economist nor politician, it is not for me to characterize the depth or nature of the current financial crisis. However, on any view, it is one of the most serious that the economies of the world have seen. Nor, at the present time, would it be apposite for me as a lawyer and a judge to try and analyse the causes of the present crisis or in any way to speculate as to what might emerge from it.

However, in the current debate on the future regime for financial markets, there is an important contribution lawyers can make. What I wish to do is to examine the role of law and regulation in two particular aspects in relation to the financial crisis to which, in my view, insufficient attention has been given. First the need for law and regulation to operate as a consistent whole in the underpinning of the financial markets and, where fraud or malpractice occurs, the role law and regulation should play in making those responsible bear an actual responsibility for what they do - accountability.

LAW and REGULATION

(i) The rule of law as a foundation of business and finance

The operation of a market economy depends upon the rule of law and its effectiveness. Our civil law has developed over the centuries a system that underpinned the capitalist market economy. As mercantile practices developed, they would be set within a legal framework of clear rights and obligations, often by judge made law, but more recently almost entirely by Parliament. That legal framework has been premised on the practice of the mercantile community to trust those with whom they do business[2] and that they will carry out their bargains.

(ii) Regulation prior to 1980s

However, although the financial markets cannot operate without a system of law, they also require a system of regulation. There has always been some form of market regulation, but regulation under specific statutes is of relatively recent origin. For example, until 1870[3], there was no piece of legislation specifically designed to

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[1] Lord Morris of Aberavon KG QC

[2] Bowen LJ in *Sanders v Maclean* (1883) 11 QBD 327.

[3] The Life Assurance Companies Act 1870; the failure of the Albert Life Insurance Company in 1869 made such legislation inevitable. It is perhaps interesting to note that its initial history was of a steady conservative company which then embarked on a vast policy of expansion by acquisition.

regulate insurance companies. That appears to have been because until 1824, of the 39 insurance companies founded only one failed; after 1843, of the 219 established, 170 failed[4].

However, prior to 1982, apart from statutory regulation directed largely at solvency and save where the criminal law intervened or in the few disciplinary proceedings that took place, the power of regulation was effectively the ability of the chairman of city institutions such as Lloyd's or the Stock Exchange and the Governor of the Bank to remove from the system those whose conduct was considered harmful or potentially harmful. It is clear that during the 1970s that system began to crumble; for example it required a resolution at a general meeting of Lloyd's to expel someone. The system could not sustain the greater presence of foreign owned firms or the stance of a person who cared nothing for opinion. Hence, dating from the passing of the Lloyd's Act 1982 and the more comprehensive reforms of the Financial Services Act 1986 and culminating in the Financial Services and Markets Act 2000, a comprehensive system of regulation has been established.

There was certainly a perception that this comprehensive structure for regulation would control the risks in the financial markets to a much greater extent than the system it was replacing.

(iii) Regulatory control over participants in the financial markets

As reflected in the basic principle on which our law was developed, everyday business life is conducted on the assumption that you choose carefully the person with whom you do business and enter into business only with a person in whom you believe you can trust. That is so because it is quite impossible to devise a legal regime, whether by the terms of a contract or otherwise, that can in detail supervise the conduct of another party to a bargain. For example, although building contracts contain detailed provisions for supervision, unless you wish to buy yourself a dispute, you would never contemplate entering into a contract with someone whom you did not trust; it is perhaps a marked feature of a failure to understand this principle that has led many to enter into accepting a tender for the lowest price in the expectation that a contract can solve the problems. That is to misunderstand the limited role that a legal regime can achieve.

Thus it is essential that at the heart of any regulatory regime, there must be a method of ensuring that the persons who run businesses, which require regulation, are those in whom trust can be reposed and are of adequate financial strength. This was the central approach of the traditional form of regulation in the City; regulatory regimes developed a similar approach - the requirement of a fit and proper person and capital adequacy requirements.

However, although capital adequacy requirements are relatively straightforward, there is a difficulty with a fit and proper person test, in a formal system of regulation - proof. In the first Department of Trade Report on Mr Robert Maxwell published in 1971[5], the Inspectors had concluded that he was not a person who could be relied upon to exercise proper stewardship of a publicly quoted company. In 1988, when Mr Maxwell applied to the then regulator to be the chairman of the investment managers of the pension fund, he was approved. The distinguished chairman of the regulator was recorded as observing that it was "a pity that we could not exclude that crook"[6]. He was in effect driven to that view because Mr Maxwell was the kind of man who

[4] Raynes: *History of British Insurance* (1948), page 353

[5] 13 July 1971: the Inspectors were Mr Owen Stable QC and Sir Ronald Leach

[6] Report on Mirror Group Newspapers (2001), paragraph 5.6 and paragraph 2.6 of appendix 9

would have challenged the regulator in court and a regulator cannot act without hard evidence. As we concluded in the Report into Mirror Group Newspapers[7]:

> "An approval is more in the nature of a negative clearance rather than a positive approval. The public should have a clear understanding of this; there should be no expectations gap."

(iii) Regulatory control of activities: the position of the consumer

Control over entry of participants into the financial markets is by itself plainly insufficient for a system of regulation. A system must address a number of other objectives including protection of the consumer, maintenance of open and transparent markets and protection against systemic risk. The regime must clearly distinguish between such objectives, particularly between consumer protection and protection against systemic risk. Its relationship to the legal regime also needs separate consideration in each case.

The need for consumer protection is too well known to require much elaboration. Apart from attempting to protect the consumer from dealing with persons who are not fit and proper, it is also necessary to provide the consumer with a degree of underpinning, such as protection from unfair standard contract terms, the protection of deposits in a bank from bank failure and the protection of assets entrusted to custodians. But what beyond this should the law and a system of regulation do and what are their respective roles?

It is plain, in my view, that the legal regime sets a sufficient legal structure in respect of fraud, negligent misrepresentation, negligence, and breach of contract. The difficulty, however, with the legal regime is that, for the reasons to which I shall come, its cost means that it rarely provides a remedy for consumers. It was thus inevitable, if the consumer was to be properly protected, that schemes for resolving dissatisfaction evolved; most of these have now been amalgamated into the Financial Ombudsman Service which has power to examine complaints, decide what is fair and order the business to put it right and make orders of compensation of up to £100,000.

The Ombudsman's description of the service offered[8] has great similarities to traditional small claims courts, arbitration and courts of merchants. Should it therefore not be seen as in effect an alternative method of enforcing legal rights and obligations at the cost of the industry (or the state) in circumstances where the traditional civil justice system cannot really help consumers? Or is it to be viewed as underpinning a parallel regime of protection with different rights? In my view this is an issue on which debate is required. The present system has evolved without proper thought as to the overall structure and how law and the system of regulation and the

[7] Paragraph 22.39

[8] We aim to settle complaints as fairly and as quickly as we can. There are always two sides to any complaint, so we'll look carefully at both sides of the story and weigh up all the facts. If we decide the business you are complaining about has treated you fairly, we will tell you why. If we decide the business has acted wrongly and you've lost out as a result, we can order the business to put things right for you. Generally, the aim is to put you in the position you'd be in if things hadn't gone wrong. This can include telling the business to compensate you for losses of up to £100,000 - but most complaints involve much smaller amounts than this. www.financial-ombudsman.org.uk/publications/consumer-leaflet.htm

different means of enforcement relate to one another. How should it be structured? What is most cost effective? Why do we need for consumers both a regulatory and a legal regime which both create rights and obligations?

It is instructive to examine the system of principles based regulation that the Financial Services Authority adopted. The 11 high level principles are:

1. A firm must conduct its business with integrity.
2. A firm must conduct its business with due skill, care and diligence.
3. A firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems.
4. A firm must maintain adequate financial resources.
5. A firm must observe proper standards of market conduct.
6. A firm must pay due regard to the interests of its customers and treat them fairly.
7. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and a client.
9. A firm must take reasonable care to ensure the suitability of its advice and of discretionary decisions for any customer who is entitled to rely on its judgement.
10. A firm must arrange adequate protection for its client's assets when it is responsible for them.
11. A firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

Many of these principles are re-statements of legal principles in somewhat looser form and give rise to obvious questions. Are they effective for a regime of consumer protection? Would detailed rules make any difference? I have already made clear that the objective of consumer protection is a distinct objective. Should we achieve this by a broad legislative instrument such as the Unfair Contract Terms Act or should we impose a standard form of contract provided by a responsible industry or by a system of regulated agreements? Provided that (i) the contract between the consumer client and the financial institution is fair, (ii) there is a system of enforcing that contract (through an ombudsman service or the courts), (iii) there is in place a system for the protection of assets (such as a custodianship regime for investments or a deposit guarantee scheme for deposits) and (iv) those who are allowed to engage in business with consumers are subject to a rigorous fit and proper person check, the question must arise as to whether it is necessary to have more detailed supervisory regulations that require separate enforcement? If so, what should they cover? Is it in reality practicable to supervise closely the conduct of a business?

There is much to be said for the view that the traditional legal regime could protect consumers, provided it is underpinned by the state or industry protection of assets (such as a depositor insurance scheme), fit and proper persons providing financial services, fair contract terms and an effective system of enforcement through meaningful sanctions. It may well be said that the system of enforcement through sanctions is not presently effective. Could not a proper system be provided by a civil dispute resolution and enforcement regime such as the Financial Ombudsman Service and where appropriate by more effective criminal sanctions?

(iv) Regulatory control: transparent markets and systemic risk

The system of law applied in the courts has not usually been developed to address the maintenance of transparent markets and protection against systemic risk. This is properly a field for regulation, but the issues of systemic risk are so important that I would like to address a few of the many issues. Here the concern is not the impact of activities by financial institutions upon the individual, but it is the protection of the system, where because of the scale or nature of the operation of an institution, the remedy of insolvency, which is one of the traditional methods of distributing risk, is insufficient to protect the system from systemic failure.

It is clear from any examination of the history of financial disasters that identifying and protecting against systemic risk is an extremely skilled task. First it requires a person to take views contrary to the prevalent market thinking. As the former chairman of Citibank put it[9]: "As long as the music is playing, you have got to get up and dance. We are still dancing." Second it requires a detailed understanding of the operation of markets, of the instruments used, the level of capital needed and activities that can endanger an institution. Most failures occur because the nature of the transactions or the level of risk is not properly understood. Third, it requires comprehensive jurisdiction over all aspects of the financial markets; it is clear that if one type of institution which provides a service is regulated, when another means of achieving the same service as the regulated institution is devised which is unregulated, there will be a flight to the unregulated business. The clearest possible example of this is the emergence of the parallel banking system over the decade prior to 2008; it was financing an amount almost equal to the capital of the US banking system[10]. Similarly a regulated institution pursuing a core activity should not be permitted to take on a business that has fundamentally different risks or, as it has pithily been put, allowing a utility to run a casino. Fourth a means has to be found of effective regulation in a global market. Our system of regulation is largely national and of uneven quality. Global traders take advantage of it. A very clear example is the way the system was used in the trading in MCC shares between Mr Maxwell and a partner in Goldman Sachs as we set out in the report in Mirror Group Newspapers[11]; these transactions took place between 1989 and 1991, but little has changed. There have been many suggestions over the years for addressing this problem, but it is one that seems intractable[12]. Many think it is difficult to understand how it is possible any longer to tolerate regulatory or fiscal regimes that do not permit transparency and the full exchange of information. Many would argue that the time has come for the demise of the tax and regulatory haven. Fifth, there must be agreement on the form of rules required. Is it to be a loose system of principles-based regulation or a more detailed set of rules? As financial instruments and new methods of business will always emerge and cannot be controlled by regulation preventing a particular form of contract or device, then surely what is necessary is a regime that provides for transparency and disclosure, together with a draconian power to prohibit. The difficulty with the approach of detailed rules is that if detailed rules prohibit a certain kind of transaction it is extremely easy for anyone with real business acumen or legal ability to devise a transaction that is within the rules but was clearly intended to be prohibited[13]. It was that danger that the principles-based system of regulation was

[9] Interview with the Financial Times, July 2007, quoted in Kay: *The long and the short of it*, page 217.

[10] Timothy F Geithner: Reducing systemic risk in a dynamic financial system: 9 June 2008, http://www.bis.org/review/r080612b.pdf

[11] Paragraphs 9.3-9.19, 22.82-89 and 22.82-22.89 and appendix 7 of the Report on MGN.

[12] The position earlier in the decade in summarised at paragraphs 23.44-54 of the Report on MGN. The latest suggestions are in the Report of the Task Force Chaired by Jacques de Larosière, Brussels 25 February 2009 (http://ec.europa.eu/ireland/press_office/news_of_the_day/pdf_files/global_report_-_final.pdf) and in recommendation 8 of the Group of 30 Report (chaired by Paul Volcker) published on 15 January 2009 (http://www.group30.org/pubs/recommendations.pdf).

[13] Enron's use of SPVs (Special Financing Vehicles) which could be treated as independent entities if 3% of the equity was owned by unrelated individuals is a good example of the letter of the rules being

meant to overcome, but it did not achieve its objective. Sixth, it is necessary to examine again the effect of practices that have developed which might have been justifiable in different economic circumstances. In the markets, one candidate is short selling and in the professions, the extent of legal professional privilege as applied to transactional work.

(v) The expectations gap

It has long been recognised that there is an expectations gap[14]. Our report on MGN urged that much more attention be paid to this problem. However, little seems to have been done to address it. Surely it must be in the proper interests of regulators and regulated bodies, in their dealings with the public or in their pronouncements to stress the limits of regulation. Why is the public not told more clearly that any regime of regulation is limited in its scope and it can do no more than help protect? *Caveat emptor* and similar maxims are still very relevant.

(vi) The recruitment of regulators

It is self-evident that if a regulatory regime is to be effective, a regulator must be a person of the highest calibre who understands the nature of the transactions he is regulating. I hope that is self-evident from what I have already said. Too often has regulation descended into a culture of ticking boxes rather than analysis. This was apparent to us when enquiring into matters surrounding Mr Robert Maxwell[15]. Has this issue been properly addressed?

I accept that there are real difficulties. First, it is not easy to recruit persons at the height of their powers and understanding to spend time in an activity which is seen as neither carrying the rewards nor the prestige of entrepreneurial activity, whether it be in a profession or financial institution[16]. We have, to an extent, lost the culture of public service and we have never really developed the ability of people to move in and out of the private and public sectors. Second, where an industry has to pay for the costs of its regulation, there is a marked reluctance for the industry to be prepared to pay someone the salary needed to do the necessary work. One can read many observations prior to 2008 on the need for cost effective regulation. By that was meant, not regulation that was so priced as to prevent the financial disaster we have encountered, but regulation that was priced so it was not too burdensome of an industry. It was, in short, a misunderstanding of cost-effectiveness. In the design of any new structure of regulation, this long-standing problem of recruitment and proper resourcing must be faced up to and addressed.

Conclusion on the respective roles of regulation and the law in the operation of the financial markets

It can, I hope, be seen from the few issues on law and regulation which I have addressed that in the reviews that are taking place of the regulatory regimes, many fundamental questions will have to be asked. Surely the current crisis will have persuaded people that there are no easy answers; that it would be idle to pretend that a system can be devised that can achieve any more than reduce the level of risk not only to the consumer or professional participant in the markets but to the economy as a whole.

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used to facilitate a major financial fraud. The SPVs which were controlled by Enron borrowed money to support the price of Enron shares.

[14] See paragraph 23.35 of the Report on MGN

[15] Paragraph 23.24 of the Report on MGN

[16] This was also an issue identified at paragraph 23.42-23.43 of the Report on MGN

So far the issues I have addressed are issues relating to the legal and regulatory system needed to underpin the financial markets and to protect markets from manipulation and systemic risk, as well as protecting consumers. However, I have "no expectations gap" and therefore turn to that part of our system of law and regulation that should hold to account those responsible for failures in the financial market where this has been brought about by dishonesty, negligence or imprudence, breach of contract or breach of regulatory or professional standards.

ACCOUNTABILITY

One of the hallmarks of any democratic society is accountability. Each of the three branches of the State is accountable – Ministers are accountable to Parliament, elected representatives are accountable to the electorate and the Judiciary is subject to the public accountability of the appellate courts and to explaining regularly what they do.

In an advanced industrial democracy, it is self-evident that those who play a significant role in the financial markets, whether as directors of banks or other financial institutions, should also be subject to a proper system of accountability under the law. This is particularly the case where the present structure of the financial markets and the legal regime for insolvency[17] make insolvency with its accompanying severe personal consequences to directors an unacceptable outcome to the overall economy. Instead losses have in effect been nationalised and hence transferred to the taxpayer, whilst the profits made in previous years remain privatised. Furthermore, as I have already indicated, a system of effective sanctions may be a more effective way of enforcing proper dealings with consumers than detailed regulatory rules in relation to the conduct of business.

The question must therefore be asked as to whether we have an acceptable system for ensuring accountability and providing effective sanctions under our systems of criminal justice, regulation and civil law.

(1) The Criminal Law

The importance of an effective criminal justice system in deterring fraud and making those who commit it properly accountable for what they have done is beyond question. We do not yet know whether there have been serious financial frauds in the United Kingdom such as those alleged to have been perpetrated by Bernard Madoff or Sir Alan Stanford. As past economic crises have always brought discoveries of serious financial irregularities, it is not the least surprising to read in the last day or so reports that similar serious frauds are being investigated in the City.

Although there may be a doubt about the deterrent effect of a properly functioning criminal justice system in relation to some crimes, I do not think there can be any doubt about it in relation to crime committed in the financial markets. There was certainly a strong view, under our old system of regulation and certainly still prevalent in the early 1980s, that the detection and punishment for false accounting at the Old Bailey in 1931 of the Chairman of the Royal Mail Steam Packet Company, Lord Kylsant[18] (a leading ship owner, a former MP, holder of a number of honorific positions in Wales), had been considered a very effective deterrent for the ensuing years

[17] Many distinguished commentators have commented on the urgent need for reform so that large financial institutions can be liquidated in an orderly manner.

[18] The best short account is by Lord Devlin in *Taken at the Flood,* 1996, pp 135-7; the record of the trial is published as *The Royal Mail Case* in the Notable British Trials series (edited by Colin Brooks,1933)

But how effective is our system today? In 1983 a Committee on Fraud Trials chaired by Lord Roskill, a law lord with much experience of commercial fraud, was established. Its report, published in 1986, begins:

> "The public no longer believes that the legal system in England and Wales is capable of bringing serious fraud expeditiously and effectively to book. The overwhelming weight of the evidence laid before us suggests that the public is right."

It concluded that fundamental change was needed and recommended radical reform. It made clear its importance to our democracy in the light of the free market policy of the Thatcher administration:

> "The Government has encouraged and continues to encourage ordinary families to invest their savings in the equity markets... If the Government cherishes the vision of an "equity-democracy", then it also faces an inescapable duty to ensure that the financial markets are honestly managed and that transgressors in those markets are swiftly and effectively discovered and punished. Self regulatory mechanisms designed to encourage honest practices are now coming into force. Where those mechanisms are abused, the law must deliver retribution, swift and sure."

Indeed it was central to this free market capitalism philosophy advocated by Professor Milton Friedman that it should be underpinned by an effective legal framework[19].

It is fortuitous to the timing of this lecture that there is the recently expressed view of Sir Ken Macdonald QC, the DPP from 2003 to 2008, "Our system for regulating markets and for prosecuting market crime is completely broken".[20] It is hard to understate the importance of this issue, for few can doubt that Roskill was right in his view as to its relationship to a democracy where the financial markets have such a significant effect on daily life.

Let me take some of the key issues.

(i) Discovery and investigation

It is a feature of most financial fraud that it is difficult to execute without assistance. There is usually either someone who within the organisation spotted what is happening or is a reluctant participant or one that has occupied (or wishes to be seen as occupying) a minor role, or who has in his or her view, been insufficiently rewarded. A system must therefore provide every prospect to encourage whistle-blowing both by protecting the whistle-blower from the consequences of dismissal and also, if he has been engaged in the fraud, for giving full credit to his role in coming forward.

Here there has been change. The provisions inserted into the Employment Rights Act 1996 by the Public Interest Disclosure Act 1998 has improved the position of the whistle-blower and protected him from dismissal[21]. A person who turns Queen's evidence has always received a lighter sentence[22]. The Serious and Organised Crime and Police Act 2005[23] made possible a more formalised process and the current

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[19] See for example his popular work: *Capitalism and Freedom* (1962) at pages 15, 25, 34

[20] Times, Monday, 23 February 2009

[21] For an example of the operation of the provisions, see the judgment of Mummery LJ in *ALM Medical Services Limited v Bryan Bladon* [2002] EWCA Civ 1085 and the judgment of Wall LJ, *Babula v Waltham Forest College* [2007] EWCA Civ 174

[22] For current practice: see *R v Blackburn* [2007] EWCA Crim 2290

[23] Ss.71-75

Coroners and Justice Bill will extend those provisions[24]. However, as is self-evident to any practising lawyer, though not always to others, changing the law can only be one step. Whistle-blowing is counter cultural and the risks the whistle-blower undergoes are enormous[25]. It is essential that the view of society must change if whistle-blowing is to be encouraged and fraud detected at an earlier stage. If fraud is not brought to light by a whistle-blower or on an audit, then it will normally come to light on the failure of a business with much more serious consequences.

But at whatever stage it comes to light, it is facile to pretend that the investigation of fraud does not require both skilled investigators and the resources to do it. Roskill recommended organisational change[26] and the Serious Fraud Office was created. Its achievements should not be underestimated, but it has had an unfortunate press and other difficulties. Undoubtedly those who have the responsibility for investigation are subject to budgetary pressures, but given the essential need to protect the financial system, budgetary considerations should only have a minor role in the investigation of serious financial fraud and proper funding is essential.

(ii) The pre-trial process

Our record in getting cases from investigation to trial does not make happy reading. Significant improvements have been made since Roskill: committal proceedings have been abolished and cases are directly transferred to the Crown Court for management by a Crown Court Judge. Improvement to pre-trial case management has been set out in the Protocol on Heavy fraud and other complex cases[27] handed down by Lord Woolf in March 2005. There is also much more rigorous control over defence work exercised by the Legal Services Commission and real attempts made to address the problems of disclosure - the provision to the defence of documents that might assist the defence. However, it remains the case that the process is too slow and disclosure imposes great burdens on all concerned. What Roskill sought to achieve has not been realised.

It was not always thus. In 1955, Willcox[28], a Lloyd's underwriter, the auditor with whom he conspired and the other managers of his syndicate were brought to trial within 10 months of the fraud being discovered in February 1954. It cannot be claimed that this was a simple case – the business of an underwriting syndicate is not easy to follow and the fraud involved window dressing, distribution of unearned profits, overwriting and the misuse of quota share treaties. The investigation and preparation were largely undertaken by Lloyd's, who conscious of the economic damage that would be done by delay or failure, allocated the necessary resources – both financial and in terms of expertise. In the Kylsant case, Sir William M'Lintock, one of the leading accountants of his day, began his investigation for the Treasury in December 1929, when the company sought an extension of its Government loans, and completed it in March 1930. Though the Government declined the extension of the loans, the report was not made public then. At a meeting of the debenture holders on 12 February 1931 an answer given by Sir William led to questions in Parliament. Thereafter everything happened with impressive speed. A summons alleging fraud

[24] See: clause 96

[25] See in the UK: Public Concern at Work (www.pcaw.co.uk) and in the US The Government Accountability Project (www.whistleblower.org) and publications available on that site such as *Courage without Martyrdom: The Whistleblowers survival guide*

[26] Paragraph 2.44

[27] http://www.judiciary.gov.uk/docs/control_and_management_of_heavy_fraud_and_other_complex_criminal_cases_1803.pdf

[28] There is a short account in Gibb: *Lloyd's of London* (1957)

and false accounting was issued in May 1931 and the Old Bailey trial began on 20 July 1931[29].

After two decades of procedural reform, can we claim that more procedural reform will help? The answer to that is "no", unless it is even more radical than anyone has hitherto contemplated. The real change required, in my view, is a major cultural change on the part of everyone engaged in these cases – they can and must be dealt with more simply and quickly.

It is self-evident from the Kylsant and Willcox cases that resources in terms not only of money but of people of ability must be brought to bear. The proper deterrence and prosecution of financial fraud should be recognised as essential to our economic wellbeing. Just as the Committee of Lloyd's in the prosecution of Willcox devoted substantial resources to ensure that that fraud was investigated and prosecuted by the ablest in the land, so we should be taking the same attitude towards fraud in the financial markets today. We should measure our expectations in terms of getting the case to trial from the time when a fraud is discovered, not when it is charged. Would the year taken in Willcox seem unreasonable to the general public? Certainly not, but to the practitioner in such cases today, it would seem revolutionary. It is that revolution in culture which we must achieve.

Where the case is clear, guilty pleas should be obtained at as early a stage as is possible. Plainly the most beneficial way of achieving a guilty plea is to present a properly investigated case to which there is no answer and to ensure that a trial can take place quickly, if there is no plea. All experience points that way; it concentrates the mind. Early guilty pleas therefore should be a by-product of efficient investigation, the known reduction in sentence for an early guilty plea, and a system that will bring the case to trial quickly. Consideration is being given to the introduction of a plea negotiation framework as set out in a consultation launched by the Attorney General in April 2008[30]. This is a practice much used in the United States and Canada. In the United States about 90% of all criminal cases are dealt with by plea agreements where the court generally accepts what is agreed. It is said that agreement in the United States is achieved by the prosecutor laying charges that carry high penalties and making it clear that a high penalty will be sought, but then compromising by agreeing to press for a penalty that is much less. In England and Wales, we already have a system where an individual can offer to plead guilty on a basis acceptable to the prosecution[31]; we also have a process for obtaining an indication from a judge prior to plea of the likely sentence he will receive[32]. There is plainly scope for developing these procedures in accordance with our legal regime under which the court decides whether the basis on which a plea is made is acceptable and what the appropriate sentence is in accordance with guideline cases and guidelines from the Sentencing Guidelines Council. Under our system all takes place in open court and is fully transparent. The procedure has developed in this way to protect not only the public interest by ensuring that the basis on which a plea is made reflects the criminality and hence the sentence (and not budgetary pressures to avoid the expense of a trial), but also the defendant from improper pressure.

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[29] The unsuccessful appeal was heard in November 1931 – it lasted 3 days, [1932] 1 K.B. 442 (1932) 23 Cr. App. R. 83

[30] http://www.attorneygeneral.gov.uk/Fraud%20Review/The%20Introduction%20of%20a%20Plea%20Negotiation%20Framework%20for%20Fraud%20Cases%20in%20England%20and%20Wales-%20a%20Consultation.pdf

[31] R v Underwood [2004] EWCA Crim 2256

[32] R v Goodyear [2005] EWCA Crim 888

(iii) The trial process

Roskill recommended several changes to the trial process. Many have been made such as electronic presentation of evidence and changes to the law of evidence to permit easier proof of foreign evidence and the admissibility of hearsay. But still the criticism of our trial process for financial fraud has been sustained. This was not the case in the first part of the 20th Century and earlier. The trial of Lord Kylsant and his co-accused, a partner in Price Waterhouse, occupied nine days in 1931. The jury retired at 3:33 pm. Three hours later at 6:33 pm (after two questions from the jury were answered by the judge) the jury gave its verdicts, acquitting the accountant and convicting Lord Kylsant on one of three counts. The trial of Willcox and his accomplices lasted 21 days. It is a notable feature of those cases that in Kylsant's case he was prosecuted by Sir William Jowitt, the Attorney-General, and defended by Sir John Simon – both leading politicians and future Lord Chancellors; Lord Kylsant's co-defendant was defended by Sir Patrick Hastings. Willcox was prosecuted by Sir Hartley Shawcross. It is apparent from the transcripts of the trial in Willcox that not only was it properly investigated, but there was

- Proper co-operation between judge and counsel
- A concerted effort to keep the information essential not to overload the jury
- Much was achieved by agreed schedules and extracts
- Sensible concessions were made
- Technical points were not taken
- Cross examination was short and to the point

I regret to say that in few modern trials could all those features be properly identified. No judge would be able in a case of serious fraud in the financial markets to begin his summing up as Streatfield J did in Willcox in 1955:

> "Members of the jury, you and I have had the misfortune of having to try in this court case now in its 20th day, which, not only for the length but for the complication, must be something of a record, even at the Central Criminal Court...."

or end it by saying:

> "I cannot remember a case in the whole of my experience of the practice and administration of criminal law, where a jury has shown more meticulous attention to a case than you have and I hope that among the many visitors that have come to this Court in the last 20 days, there may have been some from overseas where they are not so familiar with jury practice, and I hope that they will have seen in this number 1 Court how the English jury system works."

Though due allowance must be made for the changes that have occurred, it is unacceptable that the length of trials are meaused in months rather than weeks. The frontispiece to the report of the Roskill Committee reminds the reader of Psalm 84, Verse 10,

> "For one day in thy courts is better than a thousand"

and the words of Magna Carta, paragraph 40,

> "To no-one will we sell or to no-one will we deny or delay right or justice".

It is often said that financial fraud is complex. But the essence of most frauds is simple and, though we have much more paper and electronic materials for which proper allowance must be made, it should be possible to explain the fraud to a jury in terms that can readily be understood. After all, a Ponzi scheme is not a difficult

concept. Trials must come to a conclusion by focussing on the essential points. As Lord Devlin observed in his comment on the Kylsant trial:

> "It could have been made to look as difficult as any serious fraud case and it could have been made to last as long. But in 1931, a fortnight was a very long time for a case to take. In this instance the defendants were represented by highly skilled counsel. They were all men of the top quality who had learnt by practice to say a great deal in a short time."

None of this would seem the least unreasonable to the general public, but it is another major cultural change to bring about that which is needed. We have to forgo the notion that it takes as long as it takes. If this cannot be done in a way similar to that done in the Kylsant and Willcox trials by those appearing for the parties following the examples of good practice I have given, then it seems to me inevitable that consideration will have to be given to measures such as time limits and other mandatory rules. There is also the even more radical solution, as the Roskill Committee recommended, of such trials being conducted by a judge sitting with assessors or a judge alone. S.42 of the Criminal Justice Act 2003 made provision for trial by judge alone, but the necessary resolutions to bring into force have not been passed.

(iv) Sentencing

Although the damage that those who facilitate the trade in hard drugs do can easily be seen and their criminality is self-evident, people had, until the recent crisis, perhaps forgotten the very real and serious damage that those who commit financial fraud can cause to the economy and the lives of ordinary people. Those who commit financial fraud are real criminals and should be treated in exactly the same way as other criminals. There is force in the harsh criticism by Sir Ken Macdonald, QC of the inadequacy of sentences for fraud; he pointed out that an illiterate mother of five who is a drug mule from a village in The Gambia would receive a sentence five times that of a millionaire city fraudster. It is Parliament that fixes the maximum sentences. For theft the maximum sentence is 7 years, for fraud (except in cases of cheating the Revenue) it is 10 years.

In a time of financial crisis, the view is very different. Vengeance tends to dominate. This is nothing new. In the aftermath of the South Sea Bubble, Viscount Molesworth called for the directors of the South Sea Company to be declared guilty by Parliamentary fiat and to suffer the Roman punishment for parricide – being sewn into a sack with a snake, cockerel and monkey and thrown into the river to drown[33]. Although vengeance must not in any way govern the level of sentences, it surely is right that consideration be given afresh by Parliament to the level of sentence that is available under legislation for sentences for fraud and theft of very large sums of money in circumstances where serious damage is done to the national economy. Although the sentence of Lord Kylsant was 12 months, sentences in the 1920s were much higher. Bevan[34] was sentenced to 7 years in 1922 for fraud in connection with the failure of the City Equitable Fire Insurance Company and Clarence Hatry, chairman of a conglomerate of investment trusts and other companies to 14 years in 1930 for false pretences and issuing fraudulent share certificates in an attempt to

[33] Carswell: *The South Sea Bubble*(1960) at page 174

[34] The board of the company was notable for its grandees. They left the business to him and asked no questions. He had disguised the loss the company was making by creative accounting. He attempted to escape justice by flight to Vienna.

borrow funds for a takeover. As a contemporary report noted[35], two of those years was ordered to be spent doing hard labour:

> "For the first two weeks of his sentence, he must sleep on bare boards. For 28 days the man whose champagne suppers were the talk of Mayfair must crush rock on a stone pile. After that he will be given the slightly less difficult task of making mail bags".

Conclusion

The real need for proper and effective prosecution as a means of accountability in such cases was made clear by Wright J, one of the great commercial judges of the twentieth century in the course of his summing up in the trial of Lord Kylsant:

> "..... it is an important case, because it has involved the ventilation in the City of London and in this Court of many questions connected with the finances and accounts of companies – a matter of the very highest public importance. I am bound to say, and I say it because of things which have fallen from time to time quite properly and not unnaturally from various speakers in this case, that, quite apart from any question of success or failure, I think that the prosecution in this case has been, and will be, of very great service to the commercial community."

(2) Regulatory accountability

I have already outlined the emergence in the UK of our present system of regulation. Although there has been much criticism of the failure of regulators to identify and prevent many of the practices that have brought about the present financial crisis, it is clear that in the period since 1982 a real effort has been made to improve the system of discipline under the regulatory regime. However, it is clear that these are subject to two serious defects.

In the first place, disciplinary proceedings are still too slow. There is ample scope for appeal and for delay.[36] Second, and much more serious, the regulatory system has its limitations as a proper way of holding people to account. Its proper function is to hold those accountable who breach professional standards or regulations where there is no dishonesty or fraud. Fraud and dishonesty by those in the financial markets must be dealt with through the criminal courts. It cannot be right that a person who acts dishonestly in obtaining money from the Social Services is arraigned before the criminal courts and sent to prison, whereas someone who dishonestly obtains money or an advantage in the course of a financial transaction is dealt with by a regulatory sanction such as a fine or disbarment from conducting a trade. Such a city trader is just as much a common criminal as the person who defrauds social security and must be treated as such. The damage caused is often much more serious and the punishment inflicted should reflect that fact. Accountability for dishonesty and fraud by those who work in the financial markets must always, in the first instance, be before the criminal courts, before disciplinary sanctions, such as expulsion, from a profession[37].

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[35] Time, 3 February 1930. He had had an ostentatious life style (a house in Mayfair with a roof swimming pool and his large yacht); he also attempted to escape justice by fleeing to Italy

[36] An example of what can happen can be seen in an attempt to disqualify directors of a company who were said to have missold structured products to consumers: see *The Secretary of State for Business Enterprise and Regulatory Reform v Aaron & Ors* [2008] EWCA Civ 1146.

[37] Consideration is being given to giving the Crown Court power to impose such sanctions, consequent upon a recommendation of the Fraud Review.

(3) Civil accountability

The contract breaker, the negligent adviser, the negligent director and the maker of a negligent misstatement, as well as the dishonest, can all be made liable under our civil law. It is impossible to believe that the current crisis was the fault of no one.

Very broadly our civil legal framework could therefore provide a further means of accountability; it is particularly important that where very high rewards are paid to those who occupy senior positions, they should not be in a position where their remuneration is protected without there being a realistic liability for loss brought about by breach of contract or negligence. Criticism can be levelled at certain more recent developments – such as the narrowing of the scope of the duty of care owed by auditors[38] by limiting those to whom they are responsible or the provisions of the Companies Act 2006[39] which permits auditors to agree with companies the amount of a limit of their liability. But by and large our system does provide the necessary rights and obligations.

However, accountability through our civil justice system has two major problems. First (and less serious) there is no easy process under which a number of people who suffer financial loss as a result of negligence can bring a collective action. The Civil Justice Council published in December 2008 a paper on improving access to justice through collective actions.[40] A response is expected from the Government in the spring. If the proposal for collective actions is accepted and applied to losses in the financial markets, then one of the obstacles will have been removed.

Secondly and much more serious is the sheer cost of our legal system. For all but the very poor or the very, very rich, the sheer cost of litigation together with the rule the loser bears the reasonable costs of the other party, deters the enforcement of rights through the civil justice system. It is heartening to know that a thorough enquiry is being undertaken by Jackson LJ.

It is therefore hardly surprising that, at the present time, in an attempt to circumvent this, a Scottish QC tried to use the small claims procedure before the Oban Sheriff's Court (where there is no liability for costs) to launch a claim against the Royal Bank of Scotland in respect of its capital raising prospectus issued a few months before the collapse of the Bank. He was reported as saying:

> "It is a remarkable state of affairs that the directors of a great company can run it into the ground without answering in court for their behaviour."[41]

The case was abandoned when the Judge ruled that it should be heard under an ordinary procedure where there would be liability for costs[42]. As the judge held, small claims were never intended for such purposes. However, it would be a sad reflection on our legal system if it is the only effective remedy available.

It is, however, the case that a director of a company who negligently conducts the affairs of the company is liable to the company[43]. The directors of most significant

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[38] Caparo Industries Plc v Dickman [1990] 2 AC 605

[39] S.534-538

[40] www.civiljusticecouncil.gov.uk/files/Improving_Access__to_Justice_through_Collective_Actions.pdf

[41] Sunday Times, 19 January 2009; Independent 26 February 2009

[42] Independent 26 February 2009; http://news.bbc.co.uk/1/shared/bsp/hi/pdfs/26_02_09_hamilton.pdf

[43] In *Re D'Jan of London Ltd; Copp v D'Jan* [1994] 1 BLCC 561 Hoffman LJ made clear that in his view, "the duty of care owed by a director at common law is accurately stated in s 214(4) of the Insolvency Act 1986. It is the conduct of –

companies have D&O insurance apart from their own personal wealth. It will be interesting to see whether the new management of companies bring proceedings against former directors. It may be thought that there would, in relative terms, be little financial gain to the company given the overall losses, but might not this be at least one way of holding the former directors publicly to account and making them suffer the penalties insolvency would otherwise have brought about?

Finally I must emphasise that civil sanctions cannot be an alternative to criminal sanctions where there has been criminal conduct by participants in the financial markets. For the very reason I have given, those who commit crimes in the financial markets are just as much criminals as the drug trafficker or the burglar. Civil Recovery Orders[44] should follow criminal sanctions and should not, save in an exceptional case, act as a substitute for seeking criminal sanctions[45]. It is criminal sanctions that are effective as they are the most feared, as well as treating criminals in the financial markets for what they are and in a way no different to other criminals.

(4) Other accountability

Although these are the principal forms of accountability, there is also the accountability of having to explain conduct to an enquiry, such as an enquiry under the Companies Act or by a Parliamentary Committee. Enquires under the Companies Act are now rare, but public appearance before Parliamentary Committee are proving valuable. However, although adverse comment by an enquiry can have for some serious consequences, there are those who are quite impervious to such adverse comments, as is demonstrated by Mr Robert Maxwell. I regret to conclude that in my own experience, adverse comment has over the years become a much less severe form of sanction and a much less effective way of ensuring accountability.

Conclusion

It is I hope evident from the few issues I have tried to address that there are real question marks over the efficacy of our systems to reduce the risk of a future crisis or render those who caused the present crisis accountable. The debate about the issues for our financial markets will, I hope, be fundamental. Although much of the debate will focus on issues where economists have the greatest contribution to make, there are very significant legal issues which must be considered and unpalatable though some are, addressed in that debate.

If we do not, then we will be the less equipped to prevent the next crisis and we will not make those responsible for the present crisis accountable for what they have done.

> 'a reasonably diligent person having both – (*a*) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (*b*) the general knowledge, skill and experience that that director has.'

The duty is now embodied in s. 174 of the Companies Act 2006.

[44] Under Part 5 of the Proceeds of Crime Act 2002

[45] . S. 2(6) of the original provisions of the Act (now repealed) and s.2A (4) (a new section inserted by the Serious Crime Act 2007) provide that any guidance given "must indicate that the reduction of crime is in general best achieved by means of criminal investigations and criminal sanctions". The Serious Fraud Office, since acquiring powers in April 2008, has only used a civil recovery order once in place of criminal proceedings: Balfour Beatty agreed on 6 October 2008 to pay £2.25m under a Civil Recovery Order in place of criminal prosecution in a foreign bribery case:
see http://www.sfo.gov.uk/news/prout/pr_582.asp?id=582