Fraud and Financial Scandals: A Historical Analysis of Opportunity and Impediment

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Abstract

The paper presents a conceptual framework of financial fraud based on the historical interaction of opportunity and impediment. In the long run the character of opportunity is determined by the technical characteristics of assets and their unique, unknowable or unverifiable features. Impediment is promoted by consensus about the real value of assets, such that through *active* governance processes, fraudulent deviations from real value can be easily monitored. Active governance requires individuals in positions of responsibility to exercise a duty of care beyond merely being honest themselves. Taking a long run historical perspective and reviewing a selection of British financial frauds and scandals, from the South Sea Bubble to the Global Financial Crisis, the paper notes the periodic occurrence of waves of opportunity and the evolutionary response of passive governance mechanisms.

Keywords: Financial fraud; South Sea Bubble; Railway Mania; Royal Mail Steam Packet; Slater Walker; Polly Peck; Global Financial Crisis

JEL: M41, M42, M48, N23, N24, N83, N84

Introduction

To paraphrase Santayana's famous aphorism, those who do not learn from history are doomed to repeat their mistakes. Yet historical mistakes are repeated perhaps most commonly in the case of fraud and financial scandal. To devise effective mechanisms to combat fraud, whether based on improved regulation or more efficient market mechanisms, requires us to learn from past mistakes. Yet fraud seems to be the most perennial feature of business activity and its most intractable problem.

The paper analyses the history of fraud and financial scandal and identifies some common features. To do so it develops a conceptual framework based on the long run interaction of technology and market development. These features lead respectively to problems of context specific asset valuation and value verification, which taken together define the environment of mispricing opportunities. Such opportunities do not in themselves lead to specific fraudulent transactions, but do influence the probability of their occurrence and their character. Thus, whereas particular frauds vary in terms of the specific opportunity, motivation and ex post rationalisations of the individuals involved (Cressey, 1953), historians might focus on the factors that make frauds more or less likely.

A historical approach may accordingly explain why frauds and scandals tend to cluster in certain time periods. The paper begins by developing a conceptual framework based on the dynamic interaction of opportunity and impediment. It then presents a brief history of fraud and financial scandal in the United Kingdom, in three broad periods. The first, on manias and frauds before and during industrialisation, examines the features of frauds that became common in subsequent events. The second period begins by considering Victorian frauds and the notions of reasonable business behaviour and honesty as substitutes for direct intervention in corporation's affairs, which have survived largely unmodified through a series of twentieth century frauds. The third details the period since 1980 during which time the process of financialisation compounded earlier circumstances leading to fraud opportunity, culminating in financial crash of 2007-2008. The final section draws conclusions referring to limitations of the conceptual framework whilst noting the value of a historical approach for the purposes of identifying the long run determinants of fraud and financial scandal.

Conceptual framework

Taking a long view of financial fraud allows systemic causes to be more easily identified, leaving aside the psychological and individual circumstances surrounding specific cases. Most notably, frauds and scandals appear to occur in clusters, which are also cyclical in nature. The first of these, the South Sea Bubble of 1720, featured a large number of similar fraudulent projects. The same could be said of mispriced railway flotations of the nineteenth century, the accounting frauds in the UK in the late 1980s and in the US in the late 1990s, or the scandals that came in the wake of the global financial crisis of 2007-2008.

Such intermittent clusters are suggestive of common features, based on the balance of opportunity and impediment. To structure our analysis it is useful to consider what these might be from a conceptual point of view. If we begin by considering any financial misdemeanour, a common attribute is the opportunity to mislead a third party about the value of an asset or collection of assets. Such opportunities are mitigated where there is agreement about asset value and such agreement is transparent. Note there are two conditions. The first, agreement about asset value is, for example, more difficult in the market for second hand cars and easier in for new ones. Newly produced cars possess a common cost base and uniform quality assured features. The second dimension complements these asset features, which is the transparency of the basis of agreement. New cars are more easily subjected to standard and independent testing, industry association kite-marking and warranty provisions. Second hand car values are less easy to verify, leading to individual but costly quality signalling, as in the famous 'market for lemons' argument (Akerlof, 1970). Price lists for second hand cars can be constructed on the basis of common and verifiable features, such as age, but in general verification of true asset value is problematic or costly and such assets present opportunities for the unscrupulous seller, or demand additional vigilance, or activism, on the part of the buyer.

The complexity of the asset, and the ability to verify its value, therefore present important challenges to those who would enforce financial fair play. Technological change alters the nature of net assets, and the character of future cash flows, either as a function of new assets with unknown properties or their effect on the obsolescence of existing assets. Technological change therefore poses a fundamental problem for *accounting valuation*. At the same time, the presence of information asymmetry creates the problem of *dominant insiders*, either as market operators, or senior managers. Note that the dominant insider is a function of market inefficiency and may exist even where technology is stable. Where technology is also dynamic, market inefficiencies are compounded.

From the perspective of history, technology and value verification have important properties. Technology can advance steadily within a given paradigm, or change suddenly through new, breakthrough, discoveries. In the case of steady advance, the market and market participants have the opportunity to value and refine notions of accurate value. In the case of disruptive periods of rapid technological change, the old rules of valuation no longer apply, and indeed established technology loses value suddenly through obsolescence. New technology is at the earliest phase understood by only a minority of innovators who may themselves be uncertain of market potential and therefore value. Mispricing opportunities, which might occur with or without fraudulent intent, are consequently more prevalent in periods of technological discontinuity.

Value verification is similarly historically contingent. Early phases of market development impose limits on accurate pricing, for example where there are small numbers of buyers and sellers, thin trading and so on. Even so, market development through historical time and greater market depth do not in themselves promote market transparency. Over the long run, there is what might be described as a process of 'financialisation' of society, in which financial market participants, financial institutions and financial elites gain greater influence over economic policy and economic outcomes (Palley, 2011). Such processes can be reversed, but also tend to reappear and therefore recur at different times in history, for example in the decades before 1914 and more recently with financial deregulation since 1980. Features of financialisation that compound the problem of value verification include multiple principal agent relationships, differential access to information by elites and insiders and perverse incentives. Sub-prime lending prior to the global financial crisis of 2007-2008 contained all three of these features. Financial obligations were packaged and resold, at a time when interest rates and market prices were subject to insider manipulation and accountants and ratings agencies subjected to incentives to produce optimistic valuations of complex assets.

Drawing these concepts together leads to a general conceptual framework based on opportunity and impediment. As the discussion has so far suggested, technology and market development can be linked to the prevalence of fraud opportunity, but are themselves governed by broader exogenous factors. Nonetheless, each leads to the more specific issues of asset complexity and value verification. The interaction of these two features then gives rise to specific opportunities for mispricing, which include the technical characteristics of assets, the nature of principal agent relationships, the role of elites and insiders, and the effects of incentives. Conversely, from a regulatory point of view, each of these opportunities for fraud could be envisioned as an area for setting fraud impediments, using a variety of legal and institutional mechanisms. The relationship between opportunity and impediment is viewed as dynamic, with the former creating a reaction for the latter, which in turn is undermined by new sets of opportunity. To examine the interaction of these relationships through time, a specific country focus is required. The next section reviews the history of the relationship, based on an analysis of selected leading cases from British business and economic history.

A short history of financial fraud

Manias and frauds before and during industrialisation

The South Sea Bubble provided an early illustration of the power of insiders in possession of difficult to value assets in the absence of effective market scrutiny. At the centre of the scandal was the transfer of government debt to the South Sea Company, whose shares were then subjected to a speculative mania. The scheme was contrived such that all stakeholders, including shareholders, but also the government and annuity holders, had a collective interest in the share price increasing (Chancellor, 2000). The proceeds of share issues were used to fund dividend payments, with the intention of attracting further investment, so that the bubble had some of the features of a Ponzi scheme (Garber, 2001). Consequently, the lack of underlying value being created by the company and therefore the degree of mispricing became quickly obvious and the unsustainable share price collapsed. The victims of the bubble were those shareholders left with worthless shares and capital losses in the absence of any scrutiny, objective judgement or advice from market operators and institutions. For the first time in history, an auditor was employed to investigate fraudulent practices (Giroux, 2014), and found that the directors of the company and also government officials, including the Chancellor of the Exchequer, John Aislabie, were implicated in bribery and corrupt share dealing (Dale, 2004).

The bubble extended well beyond the South Sea Company itself, and included a large range of "bubble" companies. In some cases these represented genuine investment opportunities where the value of the proposed investment could be easily verified. In most cases however, either one of both of these features were absent. Some, for example Puckle's machine gun, were based on apparently elaborate technical specifications, but which, by corollary were difficult for non-expert investors to verify. Others were difficult to verify for reasons other than technical specification, such as geographical distance, for example related to the exploitation of mineral rights or monopoly trading rights in overseas locations. Some were simply implausible, such as the proposed machine for perpetual motion. Many were bizarre, such as the scheme for importing jackasses from Spain in the name of a deceased clergyman (for these and other examples, see: South Sea Company, 1825, pp.70-84).

The practical effect of these schemes was that the probability of future cash flows and profits could not be easily verified. Notwithstanding the development of discount-based methods, such as risk adjusted years' purchase (Harrison, 2001), valuation was problematic because either the technical specification was complex or there was no practical way of verifying the existence and value of the assets being sold. A further complication was the pricing of calls on subscription shares (Dale, Johnson and Tang, 2005, but c.f. Shea, 2007). In such an environment, opportunities for fraud arose from the uncertainly of valuation of the underlying asset and the absence of agreed and transparent valuation methods. The reaction, which was to outlaw incorporation other than through charter under the *Bubble Act* of 1720[1], was not extreme in this respect, although it had wider ramifications for economic development. The regulatory reaction was reasonable in an environment where information asymmetries suggested in promotion schemes appeared beyond practical regulation. At the same time, information asymmetry and the lack of access to information for the typical investor significantly inhibited market efficiency and transparency.

By the first half of the nineteenth century the situation had changed somewhat. Industrialisation brought common replications of technical solutions with standardised

[1] *Bubble Act* [1720] 6 Geo I, c 18.

components and units of output, which were increasingly common by 1850. Centralisation of production in factories reduced the opportunities for embezzlement that had prevailed in the putting out system, enabling the complementary functioning of surveillance and accounting controls (Toms, 2005). Increased scale and accumulated wealth also meant that joint stock based finance could once again be accorded legal legitimacy.

The environment in which new companies were now allowed to operate, was, nonetheless, inauspicious. Railway promoters like George Hudson were at the centre of new scandals, once again exploiting a new wave of technology that was not well understood by investors. A contemporary journalist, David Morier Evans described the railway mania as a new alliance between dishonesty and financial sophistication (Wilson and Wilson, 2013, p.15). Cash flows expected from investments were not well understood, and uncertainties were compounded by the use of creative accounting methods. For example, uncertainty over the division of expenditure between capital and revenue was exploited by unregulated directors and company promoters (McCartney and Arnold, 2000). Railway companies would reduce their depreciation charges to justify dividend payments. In turn, dividend distributions were instrumental in attracting new investors. In the absence of shareholder protection regulation, investors rationally demanded high dividend payments (Campbell and Turner, 2011). Many of the investors had accumulated profits from unincorporated businesses in other industries, and notably included the cotton merchants and manufacturers of Liverpool and Manchester (Chapman, 2003, pp.103-104).

As the state receded from interference, as in the first half of the nineteenth century, the risk of expropriation for minority shareholders increased. Sunk investments, like railways and manufacturing, require permanent capital and therefore restrictions on capital withdrawals (Lamoreaux, 2009) to protect minority investors and third party creditors. Such pressures placed limitations on dividends, whilst legal protection for minority shareholders who might otherwise suffer from the domination of powerful insiders was minimal, as the judgement in *Foss v Harbottle* case demonstrated.[2] By the mid nineteenth century, the dominant insider was well established, with decisive influence on value and its distribution.

Victorian frauds and the origins of modern regulation

Following the railway mania there were the beginnings of legal mechanisms designed to counter this dominance. Some re-regulation in the form of the Companies Act of 1862[3] inaugurated improvements in shareholder protection. An important feature was the specimen articles of association that allowed limitations on directors' power, such as democratic (one shareholder one vote) or graduated voting rights, voluntary shareholder audits, low thresholds (10 per cent) to exercise rights to call extraordinary company meetings and so on. These were relatively weak protections and investors therefore restricted directors' power by structuring their incentives and requiring most profits to be distributed as dividends (Campbell and Turner, 2011). Although the features of the 1862 Act were permissive, their effect was to encourage shareholders to play an active role in the governance of their companies, for example using shareholder committees to conduct audits. The Act also promoted the use of private companies, which did not depend on raising capital through issues to the public (Watson, 2012, p.58), and therefore had less opportunity to mislead third party investors. The post 1860 environment consequently ushered in features of corporate governance that provided some protection to investors.

Simultaneously the economy modernised further, but primarily though incremental improvements to the established coal and iron technological paradigm. Where technology is stable or incremental, the main opportunities from fraud come from market manipulations, such as market rigging or abuse of insider knowledge arising from market inefficiencies and

[2] *Foss v Harbottle* [1843] 67 ER 189. The court will not interfere with the wishes of the majority of members in a general meeting.

[3] *Companies Act* [1862] 25 & 26 Vict. c.89.

lack of transparency. In the 1860s for example there were cases affecting banks, including Overend Gurney, 1866, which issued a prospectus whilst technically insolvent and collapsed soon afterwards (Ackrill and Hannah, 2001) and also the railways and money markets. Again, these were subject to market manipulation style activities by insiders (Johnston, 1932), New legislation for railway accounting in 1868 failed to address fundamental issues of capital and revenue distinctions and associated valuation issues (Georgiou and Jack, 2011). Even so, there were no significant waves of corporate scandal in the period immediately after the reintroduction of limited liability.

There were nonetheless individual and damaging cases. In the months before its collapse in 1878, the City of Glasgow Bank had been using company funds to purchase its shares, thereby deceiving investors about its true value (Acheson and Turner, 2008). The practice was declared illegal in the subsequent case of *Trevor v Whitworth* (1887).[4] Following legislation in the form of the Acts of 1879 (Prosecution of Public Offences) and 1890 (Winding-up),[5] standards expected of directors became higher, such that criminal prosecutions of promoters or directors could be instigated by the Director of Public Prosecutions or the Board of Trade (Taylor, 2013). A distinction was made between the criminalisation of dishonesty and intent to defraud, and what might be considered normal trading transactions (Wilson and Wilson, 2013). These mechanisms reduced the burdens on shareholders, who, with increasingly liquid markets and diverse portfolios, had less time to actively participate in company affairs, leading to a decline in shareholder activism. Even so, as a consequence, dishonesty might go undetected in the absence of responsibilities for vigilance in audit and other oversight functions.

In the 1890s a new wave of technical progress based on electricity, tramways, the internal combustion engine, pneumatic tyres, cycles and oil presented opportunities for the

[4] *Trevor v Whitworth* [1887] 12 App Cas 409.
[5] *Prosecution of Offences Act*, [1879] 42 & 43 Vict. c.22. *Companies (Winding Up) Act* [1890] 53 & 54 Vict c 63.

fraudulent promoter and challenges for the evolved legal framework. The career of broker and promoter Ernest Terah Hooley provides useful illustration. In 1896 he purchased the Pneumatic Tyre Company for £3m using borrowed money. He created a new board of honorary directors, with impressive aristocratic pedigree using financial inducements. The Earl de al Warr was listed as the chairman (in return, it was alleged for £25,000), and fellow directors were his Grace the Duke of Somerset and the Earl of Albemarle.[6] None of these directors had any knowledge of the business of cycle or tyre manufacture, a pattern repeated across a series of flotations in the sector in the mid-1890s. Hooley floated the Dunlop Pneumatic Tyre Company for £5m one month later. The directors retained significant ownership through the use of deferred shares.[7] Hooley had not created any value from this operation, but relied instead on inducements to journalists to publish favourable accounts of the firm's prospects, benefiting from a wider boom in the promotion of cycle industry shares. These techniques were designed to manage investors' risk perceptions (Harrison, 1980). Hooley used inside information about Dunlop licenses held by the Beeston and Grappler cycle companies, as part of a share rigging scheme, from which Hooley profited personally (Stratmann, 2012). Such details were unknowable to the investing public, particularly those relying on press reports. In such fashion, Hooley moved from one scheme to another, including the development of Trafford Park in Manchester and a plan to purchase Cuba. He was successfully prosecuted and served several terms in jail, each time returning, undeterred, to concoct new financial schemes.

Notwithstanding these shenanigans, the balance between fraud opportunity, shareholder protection and criminal prosecution operated without significant modification until well into the twentieth century. Criminal prosecution mitigated the requirement for

[6] Dunlop Prospectus, 11th May 1896, *Times Book of Prospectuses.*
[7] Founders or deferred shares were shares held by directors (who were usually the founders of the company) which received no dividend until a pre-established dividend had been paid to ordinary shareholders, and sometimes they gave the holders a right to a high share of profits once the pre-established dividend had been met (Campbell and Turner, 2011).

direct shareholder vigilance, as did the emergence of the accounting profession in the late nineteenth century. The 1900 Companies Act made incorporation more expensive and demanded greater financial disclosure, resulting in a reduction in the number of publicly traded corporations (Lamoreaux, 2009, p.27). Prudent accounting promoted the rise of professional auditors to replace amateur shareholder committees. These safeguards did not however directly protect investors, and by offering advice, professional audit firms became complicit with management and inside investors, to the exclusion of small investors (Maltby, 1999). At the height of Hooley's first round of share pushing in 1896, Lord Justice Lopes famously declared, the auditor is 'a watchdog, not a bloodhound',[8] signalling the law's limited interpretation of shareholder protection. Indeed the law took a favourable view of the insider trader, seeing their profits as a legitimate reward for risk taking, for example on the promotion of new companies, a situation that was tolerated until 1980.[9]

Insiders exploited the situation, which gave rise to a whole series of scandals in the 1920s. There were few major technological breakthroughs in this period. Indeed, the 1920s represented a crisis in the valuation of established technologies. As a consequence, the main opportunity for fraudsters was the exploitation of inside market knowledge based on the permissive regime for insiders, who indulged in market manipulations and mis-selling share issues. They included the recapitalisation of established cotton firms and newly established combines, none of which lived up to their prospectuses and often left innocent investors holding worthless assets (Higgins et al. 2015). Hooley was prosecuted again, this time for mis-selling shares in a relatively worthless cotton mill.[10] Horatio Bottomley and Clarence Hatry promoted other notorious schemes (Johnston, 1934). The activities of another fraudster, Gerard Lee Bevan at City Equitable Fire Insurance, illustrated two important sources of power of insiders. The first was the use of associated companies to move funds to cover

[8] *Re Kingston Cotton Mills*, [1896] 2 Ch. 279.
[9] *Percival v Wright* [1902] 2 Ch 401
[10] *Jubilee Cotton Mills, Ltd. v. Lewis,* [1924] A. C. 958.

losses. Hence Bevan transferred money to City Equitable from his stockbroking firm, Ellis and Company, and vice versa (Vander Weyer, 2011). The second was the lack of vigilance from his fellow directors, who were nominees and oblivious to the fraud. Moreover, the law upheld the view that their office imposed no such requirements of additional vigilance, only a duty of care to act honestly with a reasonable level of knowledge and skill.[11] In *City Equitable*, as in *Kingston Cotton*, a standard of 'reasonableness' was wheeled out, in an environment where managers and auditors had strong incentives to limit the extent of their responsibilities.

The Bevan case demonstrated that outside investors were extremely vulnerable to accounting manipulations by powerful corporate directors. In the absence of clear accounting rules and regulations, these risks persisted, and were well illustrated by the activities of Lord Kyslant in the Royal Mail Steam Packet (RSMP) case. Like the South Sea scheme promoters and George Hudson in the railway mania respectively, Kyslant paid dividends out of capital. He also used connections between companies to massage profits. By manipulating the accounts in this fashion, he went one step further than previous fraudsters. His main method was to use secret reserves to boost corporate income such that what should have been losses in 1926 and 1927 were reported as profits (Davies and Bourne, 1972). Kyslant then used these false accounts to underpin the prospectus for a new share issue in 1928.

The RMSP case differed in some further important respects from earlier scandals. Kyslant had to rely on the auditors to accept the accounting manipulation, a problem that had not troubled Hudson or Hooley. His secret reserves scheme was also designed to evade a specific loophole. In the absence of enforceable accounting regulations on disclosure, including any requirement to publish a profit and loss account, the concealment of financial balances in secret reserves was acceptable under the law (Jones, 2011). Kyslant was

[11] *Re City Equitable Fire Insurance Co* [1925] Ch 407.

convicted, but only on matters relating to the prospectus.[12] Accounting remained largely unregulated even after Companies Act 1929, although disclosure requirements grew in successive Companies Acts from 1948 to 1967.[13]

Opportunities to move and disguise assets, liabilities, income and expenditure that had been features of frauds like City Equitable were compounded in the 1960s by the development of the market for corporate control. Contested takeover bids and complex group structures provided important context for the fraudster. A crucial issue in takeover bids is the underlying value of the target company's assets and associated opportunities for manipulation. When the General Electric Company (GEC) launched a bid for Associated Electrical Industries (AEI) in 1967, the directors of AEI overvalued their stocks and contract work in progress, with the result that a £10m profit was turned into a £4.5m loss, post takeover. The flexibility of accounting practice led to the establishment of accounting rules for the first time in the UK, with consequential establishment of the Accounting Standards Committee (ASC) in 1970 (Jones, 2011, pp.129, 486-487).

The development of accounting standards became a work in progress for the ASC in the 1970s and 1980s. Meanwhile, the Slater Walker (SW) scandal, which broke in 1974, was facilitated, like GEC/AEI, by the lack of accounting regulation. SW also demonstrated further problematic consequences of the emergence of the market for corporate control. SW's main function was the buying and selling of businesses, with the prime objective of raising its share price. Such transactions were often conducted in haste, with little knowledge demonstrated of the underlying business or their inherent value (Toms et al, 2015). SW's chief executive, Jim Slater used creative accounting to present a rosy picture and increase his own reputation in the City. After the scandal, investigative journalist Charles Raw (1977,

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[12] *R v Kylsant* [1931] *1KB 442.*

[13] *Companies Act* [1929] 19 & 20 Geo.5 c.23. *Companies Act*, [1948] II & 12 Geo. 6. *Companies Act [*1967] c. 81

pp.235-238) demonstrated the effect of creative accounting on profits and apparent value in the SW subsidiary, Crittall Hope Ltd. In addition to manipulations in individual company accounts, Slater used the complex group structure to hide liabilities and losses. His use of Ralli bank as his own banking division to underwrite the dubious assets of other subsidiaries created further opportunities to disguise the true position of the business in the short term, but ultimately left the group insolvent and at the centre of the secondary banking crisis of 1974. James Goldsmith succeeded Slater and commissioned accountancy firms Price Waterhouse and Peat Marwick to investigate SW's finances and report to the Department of Trade and Industry (DTI). His motive was to prevent a DTI investigation (Raw, 1977, p.346). Only later did it become apparent that Goldsmith was Slater's nominee.[14] Slater's manoeuvrings were indicative of new problems for regulation and oversight arising from the personal connections of the financial elite. SW also demonstrated the problems of valuing individual company assets, how those problems are compounded by complex group structures and how they are difficult to verify in the absence of accounting standards, corporate governance and effective regulatory scrutiny.

Although the consequences of SW were serious, they relatively little effect on the governance of City institutions. SW certainly contributed to the establishment of the Roskill Committee and the creation of the Serious Fraud Office (SFO) in 1987.[15] Moreover, the first legislation on banking supervision followed the SW case in an Act of 1979.[16] However, the objectives of that supervision were not specified until 1997 (Foot, 2003, p.251). Indeed, the Slater Walker aftermath was a precursor for the wave of deregulation and the associated financialisation of the economy after 1980.

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[14] HM Treasury Papers, Unwin to Bridgeman, 27th October, 1975. http://www.hm-treasury.gov.uk/d/slaterwalker_part1.pdf

[15] *Criminal Justice Act* [1987]. The SFO was accountable to the Attorney General for prosecuting criminal cases of fraud and corruption.

[16] *Banking Act,* [1979] c.37.

Financialisation and the financial crash

From 1980, greater financialisation implied changes in the structure of financial markets, lack of policy control over markets and the concentration of power amongst a financial elite (Palley, 2011). The end of corporatism and dirigisme in Europe, withdrawal of the state from the management of firms, and the advent of laissez faire and deregulation led to waves of corporate governance scandals in Europe and the US (Lamoreaux, 2009, p.30). Resulting concentrations of elite power proved problematic for regulators, and also for the efficient functioning of transparent markets.

These problems were well illustrated by the Guinness scandal of 1986. Insider trading had been a feature of the SW scandal and loomed large once again in the Guinness case.[17] The directors of Guinness and their associates, who included Wall Street financier Ivan Boesky, operated a share support scheme during the takeover battle for Distillers (Augur, 2006). Guinness directors used the company's funds to write cheques for associates to buy Guinness shares, thereby increasing the share price and the value of the share for share offer. Such practices were already illegal, based on precedent, and also new regulation against insider trading introduced in 1980.[18] To be enforced these rules required the identification of connectedness between insiders and nominees, which established a high burden of proof for prosecutions. In the Guinness case there were successful prosecutions by the SFO following a long trial, but the connectedness insider trading rules were subsequently abandoned in 1993 in favour of information access (Loke, 2005).[19]

Guinness was the precursor of a further wave of accounting scandals and frauds that broke in the late 1980s. These included Robert Maxwell and Mirror Group Newspapers, Bank of Credit Commerce International, Coloroll, and Polly Peck. Once again these scandals

[17] Slater had been convicted under s.54 *Companies Act 1948* which prohibited the provision of financial assistance for the purchase of the firm's own shares.
[18] *Companies Act* [1980].
[19] *Criminal Justice Act* [1993], s.52.

revealed the problems of subjective asset valuation. Like RMSP and SW, in all these cases profits were reported immediately before the business went bust (Smith, 1992), and were compounded by the deregulated institutional environment and complex group structures that made verification more difficult. The Polly Peck case was illustrative (Jones, 2011). The firm expanded rapidly through a series of takeover transactions between 1982 and 1989. Accounting standards were in force, but nonetheless allowed the Polly Peck Chief Executive and main shareholder, Asil Nadir, significant opportunities to manipulate his firm's accounts, particularly using the options created by foreign currency fluctuations in his group of companies. Nadir channelled funds via overseas subsidiaries to his private bank accounts, which he covered by overvaluing the subsidiary assets in the consolidated accounts.

Polly Peck and other frauds posed serious challenges for regulators in the late 1980s. Roskill (1986, p.15) commented that serious fraud was one 'in which the dishonesty is buried in a series on inter-related transactions, most frequently in a market offering highly-specialised services, or in areas of high-finance involving (for example) manipulation of the ownership of companies'. Such frauds, Roskill argued, were beyond the understanding of members of the public and by implication, beyond the purview of jury trials. Instead regulation and oversight became voluntary, based on insiders sharing similar expertise.

In the wake of Polly Peck, a new Accounting Standards Board was established, with the aim of tightening accounting rules. At the same time, with the 1992 Cadbury Report, there began a process of codification of practice in corporate governance (Jones, 2011). The process was only completed in 2003, with the creation of the Combined Code as a collection of self-regulatory principles.

Much of the Combined Code came too late for the Dot.com crash of 2001. Again, as with the South Sea bubble and the railway mania, new technology presented the markets with difficult to value assets. The decline of traditional manufacturing and its replacement with new economy firms switched value decisively from the physical and tangible to the ephemeral and intangible in firms' balance sheets. For these reasons, particularly in the US but also elsewhere, there was a retreat from historical cost based valuation in favour of market based fair value (Georgiou and Jack, 2011). New firms were, for example, priced according to website traffic forecasts rather than traditional financial metrics. These difficult to value assets left a deficit of trust between inside promoters and naïve investors (Dale, 2004). The effect was to increase reliance on regulatory mechanisms.

However the response to this demand was partial and based on voluntarism. New regulatory authorities, supplemented what later became the Combined Code. Most important was the Financial Services Authority (FSA). Established in 1997, under the Bank of England Act, the agency progressively embodied European laws aimed at restricting market abuse based on equality of access to information (Wilson, 2014). Post 1980 legislation on insider trading proved difficult to enforce because it relied upon detecting connections between parties, and was ineffective, as the Guinness scandal demonstrated. The information parity approach, which followed, further reflected European legislation, and relied on windows during which directors were barred from trading.[20] Under the FSA, regulatory oversight was enforced through administrative sanction and fines, with less emphasis on prosecution relative to the US and more on cost effectiveness and the preservation of the competitive position of the City of London (Jackson, 2005). Leading investment bankers provided the necessary expertise to staff the agency, but to provide such expertise they were necessarily drawn from banking institutions that were 'too big to fail'.

Such compromises meant that regulatory bodies were subject to capture by the political and financial elites. A leading example was Versailles Trade Finance, a partnership of businessman Carl Cushnie, a close associate of Prime Minister Tony Blair and career

[20] *Financial Services and Markets Act* [2000]; *Market Abuse Directive* [2005].

criminal Fred Clough. Like Polly Peck, they exploited the latitude within accounting standards, in this case to inflate turnover and assets, thereby defrauding investors. Political favour had promoted the reputation of the company, whilst the Combined Code failed to prevent the operation of the fraud. As in the City Equitable case, Cushnie and Clough obstructed fellow directors, in this case the non-executives. The auditors, Nunn Hayward, were also implicated by the Joint Disciplinary Scheme (JDS) for turning a blind eye to the gross inflation of turnover through the use of fictitious insider transactions.[21] These auditors lacked independence due to over-reliance of this relatively small second tier firm on what had apparently become a large client.[22]

The Versailles case was relatively small beer compared to what had meanwhile unfolded across the Atlantic and the subsequent global financial crisis. The Enron scandal, and a wave of others including Global Crossing, Tyco and Worldcom, to some extent reflected the absence of the corporate governance reforms that had evolved in the UK during the period 1992-2003. Indeed, in the early 1990s, US business successfully resisted most of the recommendations from the Treadway Report on corporate governance, preferring a model where the firm's internal hierarchy selected board members and monitored performance (Toms and Wright, 2005, p.248). The power of dominant insiders was therefore reinforced at a vital moment in US corporate history.

However, as the Versailles case in the UK demonstrated, as did the Parmalat case in Italy, neither corporate governance rules nor EU directives on market regulation were sufficient to prevent significant frauds. The effects of the dot.com crash added to the impetus for stronger regulations, which were tightened dramatically in the US in 2003 with Sarbanes Oxley Act (Sarbox), and more marginally in the UK with further additions to corporate governance codes with the Higgs (Non-Executive Directors) and Smith (Audit Committees)

[21] 'Nunn Hayward faces questions', *The Times*, 8th April, 2003. The JDS was a created in 1979 by the accountancy profession for the purposes of professional self-regulation (Matthews, 2000, p.70).
[22] *The Times*, 10th June, 2004.

Reports (2003), and marginal changes to rules on auditor rotation after the Parmalat scandal in Italy in 2005. Notwithstanding these changes, the 'watchdog not bloodhound' principle established in the *Kingston Cotton* case remained, and indeed might be characterised as 'see no evil, speak no evil'. In legal cases and auditing standards,[23] auditors were absolved from specific duty to detect fraud. Instead the responsibility was placed directly onto the senior management through their administration of internal controls (Lee et al, 2009). History demonstrates clearly however, from the earliest scandals, that dominant insiders, themselves responsible for detection of fraud, were its most frequent instigators, a point demonstrated once again in the wave of corporate scandals of the early 2000s and the global financial crisis of 2008.

Frauds were also facilitated however, by the nineteenth century principles that remained embedded in accounting and auditing standards. In the Enron led wave of scandals, the finger of blame was pointed at dominant senior managers. With attention focused on the individual scapegoats, lax accounting rules, it was argued, were not at fault. Features present in previous frauds and scandals were now writ large and indeed appeared to have become systemic. Asset mis-valuation was widespread, but occurred within the accounting rules that had developed through the various scandals since 1980, and indeed the significant tightening post Sarbox and Combined Code. As in the South Sea Bubble, the railway scandals and the dot.com bust, new difficult to value assets posed a new set of problems for valuation specialists and a new set of opportunities for market manipulators. Financial derivatives, including options, futures and swaps, but also complex combinations of these were valued by mathematical algorithms. Their complexity posed problems even for their developers, as the $4.6bn bail out of the Long Term Capital Management hedge fund in 1998 revealed. The firm's directors included Myron Scholes and Robert Merton who had been instrumental in

[23] *Hedley Byrne* & Co Ltd *v Heller* & Partners Ltd [1964] AC 465; *Caparo Industries plc* v *Dickman* [*1990*] UKHL 2; *International Standard on Auditing* 240, 'Auditors' Responsibilities Relating to Fraud in an Audit of Financial Statements' (APB, 2010).

creating derivative valuation models (Lowenstein, 2000). To be accurate these models needed deep markets and frequent trading data as their inputs. Many of the more complex derivatives, such as collaterised debt obligations were, however, traded over the counter on a bilateral basis. In the absence of market values, accountants resorted to valuation models based on often heroically optimistic assumptions (Toms, 2015).

As in previous decades, regulators were slow to catch up. New regulations tended to follow in the wake of scandals rather than anticipate their effects. In 2007-2008 and the aftermath, the effect was catastrophic. Expanded and deeper capital markets did not guarantee market efficiency or transparency. Instead, deregulation and financialisation empowered corporate insiders, who were only weakly counteracted by restrictions on their activities. The scale of the moral hazard problem was compounded by bank executive incentives, which were associated with bonus scheme complexity and bank profits, but not the level of risk exposure (Bruce and Skovoroda, 2013). Under such circumstances, 'reasonable behaviour' might be conflated with opportunities to engage in risky lending to achieve growth and shareholder returns.

Ahead of the failure of Halifax Bank of Scotland (HBOS) in 2008, as in the South Sea Bubble, all major stakeholders stood to gain from growth through further risky lending, whether executives receiving bonuses, shareholders increasing their wealth, and non executives and regulators drawn from senior positions in the Banking industry, credulous about the responsible behaviour of everyone else (Bank of England, 2015, for example, pp.217-222).[24] For some of the period immediately before the crisis, James Crosby was both HBOS Chief Executive and a member of the FSA board. Although the accounts stated that the 'performance and effectiveness of the Board and each of its Committees is evaluated annually', there was no evidence of such reviews having been carried out by the Chairman

[24] Bank of England, for example pp.217-222.

and Non Executive Directors in line with the *Combined Code* on corporate governance. In their reports, the auditors, KPMG, referred frequently to the ‘reasonable’ nature of the firms risk policies and disclosures. Individual executives themselves did what was reasonable, but were not incentivised to challenge the reasonableness of others (Bank of England, 2015, pp.33, 175, 189-192, 217-218). In short, oversight amounted to a collection of ‘watchdogs’ with strict tunnel vision, such that resulting blind spots undermined collective responsibility.

During this time, the FSA’s regulatory policy was to rely on out of court processes and administrative fines, thereby attracting criticism for failure to prosecute frauds involving pension and endowment mis-selling, or to effectively police individual financial institutions like Northern Rock. An important reason was that the burden of proof in complex cases required even greater levels of expertise than noted by Roskill two decades earlier. Prosecution was therefore expensive and risky (Croal, 2004, p.48; Wilson and Wilson, 2013). At the same time, voluntary codes of corporate social responsibility, third party regulatory agencies and multi-national firms whose activities span individual state jurisdictions have led to the rise of “private regulation” (Bakan, 2015). Even where investigations were pursued, for example HSBC was investigated for permitting money laundering involving Mexican drug cartels and terrorist organizations, criminal prosecutions were deferred in favour of fines, in this case at the instigation of senior politicians.[25] Private sector interests were conflated with the policy process through regulatory capture, applying apolitical transnational standards through informal governance processes (Tsingou, 2010, p.5). Difficult to value assets, then, coupled with misplaced incentives for insiders and their capture of the regulatory process created significant opportunities for fraud during and after the financial crisis.

Complexity, as before, benefitted insiders, particularly market operators. Market rigging scandals occurred on a regular basis. In the UK, the LIBOR rate and FOREX markets

[25] *Breitbart*, 20th April 2015

were subject to serious and fraudulent manipulations market insiders. The FOREX scandal was operated by a cartel of senior traders (“the bandits’ club”), with significant influences in the Bank of England, using inside information about client positions against the setting of market exchange rates for daily publication carried out at 4pm (Fields, 2014). There was no statutory monitoring of their activities. For example WM, the private organisation administering the ‘4pm fix’ was outside any regulatory authority, and the changes introduced in the wake of LIBOR had not been applied to FOREX (O’Brien, 2014). In short, the traders were operating a complex transaction that was poorly understood by outsiders and subjected only to voluntary codes of regulation.

Conclusions

The above discussion has been wide ranging and has necessarily been selective in its choices of illustrative cases. Also missing has been any analysis of counter arguments against regulation, which has been implied throughout to be desirable. Certainly in the model presented here, the cat and mouse evolution of opportunity and impediment is suggestive of the reduction of the former and the enhancement of the latter. However, without technological advances from which opportunity arises, economic growth is compromised and likewise too much regulation potentially damages market efficiency. In this view, fraud is a by-product of an otherwise successful market economy, and is to be tolerated as such. To be sustainable, this perspective must show that the costs of fraud are sufficiently small and that the economy is successful notwithstanding its presence. However, where fraud damages the reputational capital of individual firms, the write offs are potentially larger than the conventionally accumulated capital arising from normal trading. Where systemic, the loss of reputation spreads to institutions. The combined effects of fraud can thus significantly raise the cost of capital for all firms and damage economic growth.

As a consequence, the effect of the financial crisis has increased the demand for historical studies such that lessons can be learned and recent mistakes prevented. In the cases illustrated, the regulatory institutions have tended to lag the opportunities presented to fraudsters. The *Bubble Act* was ex-post the speculation, railway mania attracted railway regulation, Slater Walker led to the SFO. In the long run, and in more recent decades, regulatory impediments have been watered down, mainly as a result of reduced expectations placed on senior managers, auditors and market insiders.

The lessons of history are clear. The criminal law has throughout most of history, punished dishonesty yes, but without imposing responsibility for its detection on senior staff within business organisations. Like everyone else, senior managers are expected to behave reasonably and exercise a duty of case, but if someone acts dishonestly, that need be of no direct concern to them, if they can show themselves to have acted honestly. No one is therefore expected to explicitly check for the dishonesty of others. However, this collective action problem compounds moral hazard problems resulting in a multiplication of opportunity with absence of impediment. Such problems have been most pronounced in periods of rapid technological changes, which have also coincided with deregulation. Their coincidence is most pronounced today, even post financial crisis. Many of history's apparently obvious lessons remain to be learned.

A balance is thus required, not just between the costs of fraud against the costs of regulation, but between the dominant narrative of deregulation and a counter narrative suggesting duties for regulators and high paid executives that might go beyond what is expected of the ordinary businessman or woman. Board members, in return for high salaries, should expect rigorous and frequent challenge, taking full responsibility for those in their charge as well as for their own behaviour. In other words, *active* governance; 'bloodhounds' are needed as well as 'watchdogs'.

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