



**WORKING PARTY PAPERS**

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**Response to the DTI Company Law Review  
Consultation Paper  
'Developing the Framework'**

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## CORPORATE GOVERNANCE

We wish first to acknowledge the industry and skill of those responsible for this consultation paper and in particular the sections on corporate governance, the subject with which the Panel is primarily concerned. We welcome, among other things, the decision to recommend formulation of a statutory statement of directors' duties; the proposals for a mandatory Operating and Financial Review; the discussion of the possibilities of increasing the incentive for shareholders to take an active interest in corporate governance issues; and the retention for the most part of the Part X offences.

It is disturbing, however, that the subject of fraud is not given greater prominence in either the February 1999 consultation paper *The Strategic Framework* or in the most recent paper *Developing the Framework*. There is a number of places where mention is made of fraud or abuse of power, and there is a specific proposal that a company should be liable for loss suffered by others as a result of the fraud of its directors (as we have previously advocated). But for the most part these are passing references and fall a long way short of a substantive consideration of the subject as something that has – or should have – a material bearing on any discussion about corporate governance in general and directors' duties in particular.

Among those who responded to the earlier consultation papers, we may well be alone, or among a small minority, in taking fraud as the dominant theme of our representations. For this we make no apology. The Panel exists to promote a greater awareness of and a more determined response to the threat posed to society – and to business in particular – by fraudulent activity of one kind or another: it would not therefore be surprising if our submissions have an emphasis that is not reflected in the generality of responses. In what follows, we summarily re-state the case for a substantially higher-profile treatment of the relevance of fraud to any discussion of corporate governance and, in particular, any further consultation paper on report that the Review Committee may issue.

The case rests on five propositions:-

1. Fraud and other forms of financial crime have come to be recognised by many as a world-wide threat to society. If support for this treatment is necessary it can be found in the material listed in *Schedule* to this response.
2. Although the weight of popular media attention has been directed to areas such as the NHS, Europe, and Revenue, the threat is not confined to the public sector. Commerce, and industry are equally vulnerable but have so far been slow to respond. The scale and urgency of the problem is concealed to a large extent by a reluctance on the part of management to report fraud: see for example *Schedule* reference no. 5 (Higson/Fraud Advisory Panel).
3. It is a melancholy fact that evidence suggests that a high proportion of major frauds in the private sector involve one or more members of the board or other senior management: see for example *Schedule* reference no. 3 (Auditing Practices Board Consultation Paper).
4. Any review of corporate governance and directors' duties should openly acknowledge these problems and treat them with the weight that they deserve.
5. The subject is too important to be left solely to private-sector initiatives, welcome though these are. A major DTI-led consultation on corporate governance should be a natural place for the subject to be addressed.
6. In its omission of any substantial, distinct recognition of fraud as a relevant and increasingly important factor, the DTI Review is oddly out of step with governmental pronouncements

and initiatives in other areas (as reflected, for example, in a number of the references listed in the accompanying *Schedule* references).

This last point is particularly striking.

We appreciate that a fundamental purpose of the current Review is to try to ensure that company law is put on a footing that is conducive to the generation of wealth in the modern economy, and we applaud and support this endeavour. The point of wishing to see fraud brought into the discussion at a higher level of profile than it is being given at the moment is not to ensure that a particular form of anti-social behaviour is punished: it is, rather, to secure authoritative recognition of the fact that, without a more disciplined approach, 'the effectiveness of the board as a management body' (to borrow the language of paragraph 3.126 of the latest consultation paper) will continue to be impaired and the potential for wealth generation increasingly at risk of illegitimate dissipation and diversion.

For these reasons we would like, at the very least, to see five things:-

First, a clear recognition, in any further consultation paper or report, of the fact that the risk of fraud is something that has a major bearing on the well-being of any commercial or industrial enterprise and is an issue that needs to be expressly and distinctly addressed in any discussion of corporate governance.

Secondly, adjustment of the proposed statutory statement of directors' duties so as to give greater emphasis to the idea of *stewardship* of the company's assets and interests (a term used at various points in the discussion papers, e.g. at paragraph 5.1.5, footnote 23 of the February 1999 paper and in paragraph 5.19 of the March 2000 paper, but not in the draft statement of duties) and *active accountability*, as an aspect of stewardship, for those assets and interests. (In this same context, we welcome the proposal to include a specific duty to act 'honestly', though this will also need to be considered in conjunction with whatever conclusions the Law Commission may reach as a result of its current consideration of the Law of Fraud and Deception.)

Thirdly, specific reference to fraud prevention and detection systems as one of the matters that should be covered in the proposed new OFR, under the heading *Corporate Governance or Dynamics of the Business* (see paragraph 5.88 of the most recent paper).

Fourthly, specific consideration of the (admittedly difficult) question of the extent to which management and employees generally should be under a legal obligation to report evident or suspected fraud (to the board or the audit committee, say).

And fifthly, in addition to the statutory statement of directors' duties, an authoritative guidance booklet on directors' duties (preferably one in which fraud is treated as a separate and distinct topic rather than subsuming it under the general heading of 'risks' that need to be managed). There is a need for such a publication because a statutory, high-level statement of the kind proposed is unlikely to be sufficient guidance in practice for those unfamiliar with company law.

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*Note: The Fraud Advisory Panel is an independent body established in 1998 on the initiative of the Institute of Chartered Accountants in England and Wales under the chairmanship of George Staple CB QC.*

## Schedule

1. ICAEW: *'Taking Fraud Seriously'*, 1996
2. Ernst & Young: Periodic surveys of the effect of fraud on business: *Fraud – The Unmanaged Risk*. Most recent (seventh) report, May 2000.
3. The Auditing Practices Board: *'Choices for Society'*, March 1999.
4. Law Commission Consultant Paper No. 155, *Fraud and Deception*, April 1999.
5. Dr. A. Higson, for the Fraud Advisory Panel: *Why are management reluctant to report fraud?*, 1999.
6. Fraud Advisory Panel Annual Report for 1998/1999.
7. Establishment of the new European Office for the Fight against Fraud ('OLAF') and proposals for the development of a *corpus juris* to meet the threat of fraud against the European Union: see Mireille Delmas-Marty, CML Rev. 2000, 247, based on a papers presented to the European Parliament on 13 October 1999.
8. Inland Revenue press release concerning proposed new powers to combat serious Tax Fraud, November 1999.
9. International Auditing Practices Committee proposals for revision of the international auditing standard on *Fraud and Error*, 2000.
10. CBI business guide, *Fraud: risk and prevention*, April 2000.
11. The G8 Summit in Paris in May 2000, involving discussion of common response to internet crime.
12. The recent US Federal Trade Commission identification of 1,6000 web-sites advertising suspect wealth promotion schemes.
13. The DTI initiative aimed at increasing awareness of data security vulnerability.
14. The *Partners against Crime* initiative led by the City of London Police, Metropolitan Police and CBI, May 2000.
15. Fraud Advisory Panel annual report for 1999/2000.
16. Serious Fraud Office annual report for 1999/2000.
17. DTI – sponsored Foresight Crime Prevention Panel report *Just Around the Corner*, March 2000 (Sharman report).
18. National Audit Office report on UK Ministry of Defence, May 2000.
19. Home Office Proposals – *Rising Standards and Upholding Integrity: The Prevention of Corruption*, June 2000

