A Report by

JUSTICE

THE PROTECTION OF THE SMALL INVESTOR

Chairman of Committee

David Graham QC

£5.00

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1992

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JUSTICE

British Section of the International Commission of Jurists

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JUSTICE

Extracts from the Constitution

PREAMBLE

Whereas JUSTICE was formed through a common endeavour of lawyers representing the three main political parties to uphold the principles of justice and the right to a fair trial, it is hereby agreed and declared by us, the Founder Members of the Council, that we will faithfully pursue the objects set out in the Constitution of the Society without regard to consideration of party or creed or the political character of governments whose actions may be under review.

We further declare it to be our intention that a fair representation of the main political parties be maintained on the Council in perpetuity and we enjoin our successors and all members of the Society to accept and fulfil this aim.

OBJECTS

The objects of JUSTICE, as set out in the Constitution, are:

to uphold and strengthen the principles of the Rule of Law in the territories for which the British Parliament is directly or ultimately responsible; in particular to assist in the maintenance of the highest standards of the administration of justice and in the preservation of the fundamental liberties of the individual;

to assist the International Commission of Jurists as and when requested in giving help to peoples to whom the Rule of Law is denied and in giving advice and encouragement to those who are seeking to secure the fundamental liberties of the individual;

to keep under review all aspects of the Rule of Law and to publish such material as will be of assistance to lawyers in strengthening it;

to co-operate with any national or international body which pursues the aforementioned objects.

This report has been endorsed and approved for publication by the Council of JUSTICE

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Chapter 1.

INTRODUCTION

The establishment of the Committee in 1989

1.1 The idea for a Committee of JUSTICE to look at the subject of protection for the small investor arose directly out of the Barlow Clowes affair. The collapse of the group in May 1988 as well as one of its financial intermediaries not long afterwards brought sudden and swift disaster to over 18,000 investors who had been under the impression that their savings, in most cases not exceeding £25,000 or so, were safely tied up in British Government Gilt-Edged stocks yielding a steady rate of interest.

1.2 If a calamity of such proportions could still happen despite the implementation in stages during 1987 and 1988 of the Financial Services Act 1986, there was a deep-felt belief that all might not be well with the system as a whole.

1.3 The aim of the Committee was to produce a report within a year or so. Between March 1989 and the Spring of 1991 the Committee held about fifteen meetings but it had quickly become apparent that the task it had undertaken was far more difficult and complex than was originally contemplated. The Committee did not in the circumstances have the time or the resources at its disposal to review the vast range of issues to which the problem of protection for the small investor gives rise. Accordingly the report has of necessity been confined to matters of a more general nature where it is believed that useful changes should be considered to give the small investor a greater degree of protection against the loss of his savings.

1.4 In July 1991 the Committee was able to host an informal seminar which was attended, it must be emphasised in a purely private capacity, by various individuals working in or closely connected to the regulatory industry. The views informally expressed at the seminar about the contents of the report, as it then stood, were extremely valuable and have been taken into account in formulating our final report. The views expressed by individuals at the seminar were merely of an informal nature and did not necessarily reflect the opinion of any organisations with which they might also be connected.

The complexity of the regulatory system

1.5 The Committee began by considering that it might be useful to survey the last decade or so to see what light other collapses during that period might throw on the general nature of the problems facing small investors and the adequacy of the protection available to them.

1.6 The Committee were quickly struck by the ease with which during that period a determined fraudster could cheat the small investor of his life savings. The framework of regulatory control was, certainly during the earlier part of the decade, grossly inadequate and contributed to a climate in which fraud could thrive.

1.7 The usual scenario would be for a gullible investor to entrust substantial amounts of his savings to an intermediary in the expectation that his funds would be prudently placed in a safe and solid investment providing a regular income. Far from this being the case, the intermediary would misappropriate the funds for his own benefit or would invest them in risky ventures in which he himself would either directly or indirectly have an interest. When the enormity of the intermediary's misconduct emerged, the disappointed and shocked investor would discover that there were no tangible assets into which his funds could be traced, that he was merely an unsecured creditor in a bankruptcy or liquidation with little or no hope of assets out of which he could receive any dividend, and that there was no compensation or guarantee fund to which he could look to mitigate any part of his loss.

1.8 The arrival of the Financial Services legislation was heralded as the start of a fresh dawn. However well-intentioned the original conception may have been, the massive size of the new structure as it has rapidly developed, with its formidable array of rules and regulations, is more than enough to intimidate the layman. The character of the edifice, quite frankly, appears to lawyers both acquainted and unacquainted with the subject to be just as daunting as well as extremely complex and often downright confusing. If this is the reaction of lawyers to the system, then it must be pertinent to ask what the small investor must think about it and whether his needs are being adequately met. Equally, it may be fair to point out that the very complexity of the regime may inhibit the promotion of an honest business crying out for investment from a wider audience.

1.9 The huge structure of statutory provisions, rules, regulations, codes and principles was something that struck us immediately we started to try to get to grips with the subject. As time went on an increasing feeling of helplessness descended upon many of us. The regulatory structure is simply too big.

1.10 The various encyclopedias on the subject are quite incapable of keeping up to date with amendments, additions and other statements, and, despite their size, they do not contain all the material (e.g. the Solicitors Conduct of Business Rules seemed at one time especially difficult to obtain in published form).

1.11 How then can the lay person, let alone the professional, expect to be able to cope? This feeling of being overwhelmed (something akin to wading through a lake of blancmange) never left us and gives rise to one of our recommendations considered below that there is a need for the whole regulatory structure to be examined with a view to considerable simplification.

Caution on the part of the small investor: the need for education

1.12 It is, of course, recognised that the system cannot be a substitute for a reasonable degree of vigilance on the part of the small investor and cannot be expected to guarantee to the fullest extent his investment against loss in all circumstances. However we believe that the small investor, contemplating his position under the new regime, could be forgiven for believing that he is being afforded more protection than is actually the case. This in itself, we believe, must give grounds for concern.

1.13 To the extent that the system does afford any degree of financial compensation against loss by small investors, it must demand from them a reasonable degree of prudence and caution in the placement of their funds. An acceptable level of education even of an elementary nature on a general basis in relation to simple investment matters will take time to achieve but it will not be assisted so long as the system for regulation and compensation is perceived as so complex and confusing.

Our limited objectives

1.14 As our meetings progressed it became evident that the subject is undergoing almost constant reappraisal and change at an extremely detailed level. It is quite impossible for us to keep abreast of the welter of new developments which have continued apace since our original study of the subject took place.

1.15 We have accordingly confined ourselves to a brief examination of the roots from which the present system arose with a view to making a diagnosis of problems thrown up in the past for which it may still be necessary to find solutions. We have particularly addressed problems in the area of trust law which can create difficulties incapable of resolution without complex and expensive litigation. We have also looked at the adequacy of the 'safety-net' available to the defrauded small investor in the shape of compensation schemes and considered the personal liability of partners and directors to their investors.

1.16 Irrespective of the rights or remedies arising from the loss or disappearance of the investment itself, the investor may conceivably be able to maintain claims against the intermediary by whom he was introduced to the investment. These claims may flow from breach of contract or sound in damages for negligence or under other heads of misconduct and their pursuit is likely to involve lengthy and expensive litigation which will be beyond the contemplation of the overwhelming majority of investors.

1.17 The focus of our attention has not been with the latter area of protection for the small investor but, insofar as there may have been serious misconduct on the part of the intermediary amounting to fraud or dishonesty, there may be the likelihood of insolvency as well as an opportunity for compensation under a relevant scheme. It is in this respect that this area for concern largely overlaps with the problems identified in our report.

1.18 On a somewhat broader plain we have been struck by the unsatisfactory state of the provisions under the new system dealing with the control of advertisements for and solicitation of funds from the general public and we believe that there is a strong case for improvement to ensure that misleading information is eliminated from advertising material and that the small investor is always presented with a fair and balanced view of the product into which he is being invited to invest his savings. Improvements in this respect accompanied by a more acceptable level of education in relation to financial investment will give a better opportunity to the small investor to exercise prudence and caution in his choice of investment.

1.19 Whatever, judged from an entirely domestic standpoint, may be the adequacy of the new framework of regulation for the investment industry there is absolutely no doubt from our observations that the system can all too easily be subverted by the incursions of unscrupulous and sophisticated operators from other jurisdictions. The search for a level playing field is, as regards the European Community, being actively carried on, but there are disturbing signs that a similar consistency of approach is not being given the same degree of priority in other jurisdictions with which the United Kingdom has close connections.

1.20 As part of our research we received an extremely valuable summary of the position in France regarding the small investor prepared by Jacques Asscher, a partner in the Paris office of Theodore Goddard. We should like to express our gratitude to Mr. Asscher. His summary may be obtained on request from the JUSTICE Office.

1.21 Accordingly in this Report the Committee has examined various aspects of the regulatory structure concerned with investment from the particular standpoint of the small investor (which we define in Chapter 2) and sought to make recommendations with a view to stimulating debate in this area.

Parallel areas for concern

1.22 Our concern, as already indicated, has been with the adequacy of the protection for the small investor. The parallel problems created for depositors of a collapsed bank, as in the case of the Bank of Credit and Commerce International, or pensioners where their funds have been misappropriated, as apparently happened in the case of the Maxwell group, raise problems and issues not entirely dissimilar to those discussed in our report but, although there is need for a broad overview of these various areas, we have not felt able to undertake one. However a glance at two reports, both issued on 4th March 1992 by Select Committees of the House of Commons, suggests that there is an urgent need for such a review: see the Fourth Report of the Treasury and Civil Service Committee on Banking Supervision and BCCI: International and National Regulation, together with the Second Social Security Committee Report on the Operation of Pension Funds.

Welcome Developments

1.23 In October 1991 Sir Kenneth Clucas was invited by the Chairman of the Securities and Investment Board (SIB) to undertake a study into whether it would be feasible and appropriate to set up a new self-regulating organisation for the retail sector. The report, which was concluded at the end of February 1992, was occasioned by a belief that the regulation of retail intermediaries could be carried out more effectively and efficiently, consistently with proper standards being maintained, if it were done as part of the operational task of a new self-regulatory body.

1.24 The Clucas Report is an important and welcome development in the field of protection for the small investor. The proposal for the establishment of a self-regulatory organisation in respect of investment business primarily done with or directly for the private investor would have the undoubted merit of ensuring that one arm of the regulatory process is specifically charged with the responsibility of focusing upon the small investor, the protection of whose interests is at the heart of the whole exercise.

1.25 The need to give greater consideration to the interests of the small investor as a consumer is a major theme of our report. It is particularly gratifying therefore that the thrust of the most recent developments in this field seems likely to follow in the same general direction.

1.26 The rationalisation of the roles performed by the various existing self-regulatory organisations and their members in the field of providing financial services and the recognition that an essential aspect of their work is the provision of services as a retailer would be of immense benefit to the small investor. Such an approach would go a long way to eliminate much of the confusion, complexities and other criticisms of the present system which we have time and again met or highlighted during the preparation of our report. The small investor is a consumer in the retail market-place and needs to be treated accordingly.

Chapter 2.

CONCERN FOR THE SMALL INVESTOR

The Barlow Clowes Affair

2.1 The Committee was set up in March 1989 in the wake of the collapse the previous summer of the Barlow Clowes Group. This disaster involved more than 18,500 investors in 'Gilt Portfolios' managed in this country and 'off-shore' and where the collective losses were likely to exceed £150m. The group had been in existence for nearly twelve years and since October 1985 its English arm had been licensed by the Department of Trade and Industry (DTI) under the Prevention of Fraud (Investments) Act 1958.

2.2 In July 1991 Clowes and three of his colleagues went on trial, Clowes facing eleven charges of theft, as well as charges of conspiracy to deceive and of making false statements to persuade people to invest with him. In February 1992 Clowes was convicted and sentenced to ten years imprisonment; one of his colleagues was also found guilty and sentenced to eighteen months imprisonment. The other two defendants were acquitted. It is understood that Clowes has lodged an appeal.

2.3 In passing sentence on Clowes, Phillips J. told him that this was the worst case of fraud ever to be heard by an English judge.

2.4 The overwhelming majority of Clowes' investors were resident in this country and his technique was to offer them as basic-rate taxpayers, through the 'off-shore portfolios', a high guaranteed income without deduction of income tax with four major advantages:

(i) absolute security of capital;
(ii) up to a specified amount a year income - free of tax;
(iii) prompt payment of income;
(iv) easy withdrawal.

2.5 The suggestion that the investors in Barlow Clowes were in part responsible for their fate because of their 'greed for higher returns' is far from accurate.

2.6 It has been pointed out that in fact the rates offered by the Post Office Investment Account often bettered those Barlow Clowes was offering on its off-shore funds. The difference was that Barlow Clowes was offering its returns as tax free capital gain while the Post Office returns were taxable in the hands of a U.K. taxpayer. It was the bogus tax free claim by Clowes which meant that his returns were the best on the market. Furthermore most investors put their money with Barlow Clowes through financial intermediaries who advised them to do so: see *The Barlow Clowes Affair* (Lawrence Lever), published by Macmillan in 1992 at page 276.

2.7 The misapprehension regarding the high returns offered by Barlow Clowes was also referred to by Robert Rhodes, Q.C. (who had appeared for one of the acquitted defendants in the trial) in a letter to *The Times* on 11th March 1992. He observed that the evidence at the trial was to the effect that the rates offered to investors off-shore were by no means out of line with off-shore rates offered by wholly reputable organisations and were only slightly more than those available from building societies in the U.K.

The new regime

2.8 A new regime for the regulation of the financial services industry had come into force under the Financial Services Act 1986 in April 1988. It was the Securities and Investments Board (SIB), set up under that Act as the industry's principal supervisor and watchdog, which took the initiative in bringing to a halt the activities of Barlow Clowes.

2.9 In June 1988 the Secretary of State for Trade and Industry appointed Sir Godfray Le Quesne, Q.C. to investigate and establish the facts relating to the regulatory functions of the DTI as regards Barlow Clowes and the granting and renewal of various licences and the monitoring of the activities of the licence holders. In the light of the Le Quesne report, submitted to Parliament in November 1988, the DTI declined to accept any responsibility for losses incurred by any investors.

2.10 Soon afterwards the Parliamentary Commissioner for Administration (the Ombudsman) commenced his own investigation, following complaints from investors alleging maladministration by the DTI. In December 1989 the Ombudsman reported to Parliament that he had found maladministration by the Department in relation to the handling of the Barlow Clowes affair.

2.11 Although the Department disputed the findings, the recommendation of the Ombudsman regarding the payment of compensation to investors was grudgingly accepted by the Government out of respect for his office. The overwhelming majority of investors (about 98%) took advantage of the proposals and in return assigned all their claims to the Secretary of State for Trade and Industry.

The concern of JUSTICE

2.12 Meanwhile there existed a general feeling amongst the membership of JUSTICE that, in the face of such a catastrophic disaster as that of Barlow Clowes to the investing public, and despite the commencement of the new regulatory system, it might be useful to set up a Committee to see whether in future the small investor could be regarded as having adequate protection or to what extent any reasonable recommendations could be made for improvement.

2.13 The whole of this area of the financial market at a time when the general public is being increasingly encouraged to invest and where, if anything goes wrong, the immediate consequences for individual investors and their families can be extremely serious, is under regular and detailed review by bodies such as SIB and the Office of Fair Trading. Our more limited aim has been to stand

back and survey the scene from a more distant and somewhat different perspective in the hope of learning some lessons which may be profitable in the future debates on the subject which will inevitably occur.

The small investor

2.14 There is no authoritative definition of the small investor, although the expression was used in the judgment of the Court of Appeal in Re Walter L. Jacob & Co.Ltd. [1989] BCLC 345, at 348, delivered on 21st December 1988.

2.15 The concept of the small investor is frequently encountered in the financial press and is usually employed to refer to the private individual investor or saver as distinct from the large institutional or professional investor who, unlike the small investor, will have access to sophisticated techniques as part of his business for measuring the risk attendant upon any particular investment. The small investor, by contrast, is dependent either upon his own judgement formed after considering the relevant prospectus or brochure, by comparison with his knowledge or experience of similar products, and by reference to press comment. Alternatively he may be guided by the advice of a friend or, as is now commonly the case, by a professional adviser. It is, broadly speaking, in this latter sense that we have considered the term 'small investor' throughout this report.

2.16 The primary concern of the small investor may not necessarily be the absolute safety of his investment, in which case he might be content with a lower yield; he may be willing to have a flutter and to embark upon far more speculative and risky investments. He may, on the other hand, wish to be a 'fire and forget' type investor: one, in other words, who having made his investment, prefers to leave it, often for a long period, to increase in value and yield, perhaps with a view to enhancing his savings at retirement. The degree of protection to which he can look if the investment turns sour will not necessarily have to be the same in both cases and it would, from an economic standpoint, be unreasonable for the investor to expect similar protection irrespective of any differences in the nature of the risks.

2.17 The SIB's rulebook draws a distinction between 'business' and 'professional' investors on the one hand, (such as investment businesses, local authorities and certain large corporations), and 'private' investors on the other hand: Financial Services (Glossary and Interpretation) Rules and Regulations 1990. A small investor is plainly a private investor in this context.

2.18 In September 1990 the DTI issued a consultative document, *Defining the Private Investor.* For the purposes of the new section 62A of the 1986 Act, which is intended to limit the rights of investors to sue for breaches of the rules to private investors, it proposes the following definition:

the expression 'private investor' means an investor whose cause of action arises as a result of anything he has done or suffered -

(a) in the case of an individual, otherwise than in the course of carrying an investment business; and

(b) in the case of any other person, otherwise than in the course of carrying on business of any kind, but does not include a government, local authority or public authority' (p.11).

2.19 We believe that such a definition, however, causes problems in two respects: it overlooks the possibility that an individual could be an experienced or 'professional' investor, as opposed to the small or 'amateur' investor, and it would exclude from protection a considerable number of businesses which might not have any expertise in the field of investments. (Charities, for example, frequently carry on business in one way or another).

2.20 The unsuspecting investing public has in the past ten years been bombarded with a wide range of investment opportunities, most perfectly legitimate but some, in a minority of cases, nothing more than a swindle. The difficulty for the small investor is how to avoid falling into the clutches of a fraudster. In the Langford Scott case, referred to in the next chapter, the investment was to be in local government bonds under the control of a company licensed by the DTI. In another case the victims of the fraud were blinded by the prospect of tempting profits offered by a company boasting, as its two main products, a running shoe containing stored energy and artificial limbs for race horses: see the article by Tony Hetherington in *The Times,* in December 1989, *How gullible investors still fall for City's fraudsters.*

The small investor as a consumer

2.21 The small investor in the contemporary financial world is not unlike a consumer in the domestic appliance market place. In the Final Report of the Committee on Consumer Protection (Molony Committee), published in 1962 (Cmnd. 1781/1962), the view was expressed that the old-established balance between buyer and seller had been seriously disturbed in recent years by the emergence of radically different methods of manufacture, distribution and merchandising and that, as a result, the existing system of consumer protection had become inadequate in various respects. The Report was the impetus for the foundation of our present system of consumer protection.

2.22 Changes in the financial market also require a greater degree of protection for the small investor. The job of ascertaining and soundly assessing the wide range of alternative choices open to him is more than he can possibly be expected to undertake in a rapidly changing market. Misleading or inaccurate advertisements only make this task harder.

2.23 The business of assembling an investment product is highly organised and will call to its aid at every step complex and sophisticated expert skills. The business of buying the product will, on the other hand, be conducted by the smallest unit, namely, the individual investor.

2.24 With the general increase in wealth in large sectors of society the ordinary small investor is now spending a greater proportion of his money on products sometimes of a complex nature, quite unknown not so long ago. The quality and relative merit of each is probably imperfectly understood by the vast majority of the public and even a qualified expert may have difficulty in forming a sensible view about them.

2.25 In such a maze of products, frequently heavily promoted by a campaign of press advertising or by mail-shots, the potential investor might well find it beyond his power to make a wise and informed choice and is, of course, a prey to exploitation and deception.

2.26 The vulnerability of the small investor if something goes wrong is exacerbated by reluctance to incur the considerable trouble and appreciable cost of pursuing what he regards as his legitimate complaint. This reluctance will be deepened if the outlay on expert investigation and legal proceedings is disproportionate to the amount of his savings tied up in the product, and especially if satisfaction cannot be obtained short of bringing his case to trial. Even if successful he must reckon with the possibility that the culprits are not worth powder and shot. He will not, after all, wish to throw good money after bad.

2.27 The consequences may be that those to whom the small investor can legitimately look for compensation may take the long-term view that any challenge will soon falter through lack of financial resources and they (or their insurers) will not be disposed to canvas the idea of a settlement. In any event it is arguable that any rights which the law may give to the small investor will too often go by default.

2.28 Inexorably, in the face of a common disaster, individual small investors will seek to combine, if only for solace and comfort, but in more practical terms, to give them the strength by a pooling of their resources to seek compensation where appropriate.

Minimum requirements for the protection of the small investor

2.29 We thus identified at the outset the following minimum requirements for the protection of the small investor:

(1) the requirement for access to sound, reliable, expert advice;
(2) the need for honest, accurate, informative and reliable advertising and promotional literature;
(3) an effective and speedy compensation system if things go wrong together with the requirement for swift and effective remedies against defaulters;
(4) a clear, comprehensive, straightforward and easily understandable regulatory structure.

2.30 As this report we hope illustrates we by no means found all or any of these minimum requirements satisfied. We commenced our endeavours with the aim of seeing whether the new regulatory structure was capable of protecting the small investor. We concluded them with a feeling of bewilderment and unease. The small investor ought, we broadly feel, to be better off in terms of protection than before the new regime, but we wondered whether, in fact, this was so. Recent press rumblings about the role of FIMBRA and its compensation scheme have merely served to increase this feeling of unease.

2.31 The Clucas report, to which we refer in paragraph 1.23, has now proposed the creation of a self-regulating organisation (SRO) for the retail sector in view of the increasing recognition of the desirability of distinguishing between the professional and the private investor which is likely to lead to a re-division of the boundaries between existing SROs. The rationale behind these development is given in paragraph 4.22 of the Clucas Report:

> 'The informed professional, active regularly in the market, is less in need of protection than the private individual: he needs a regulatory framework governing the conduct of business but it will be different, and in many respects lighter in touch, than that appropriate to the private investor. These differences have been recognised in the formulation of the core rules, which form a basic structure for the conduct of investment business, with the result that specific rules, such as those dealing with suitability and best advice, do not apply to business transacted between professional investors.'

2.32 The general thrust of the Clucas Report is to be welcomed and is further evidence that our own original misgivings concerning the small investor were by no means misplaced.

Chapter 3.

THE HISTORICAL DIMENSION FROM DEFOE TO GOWER

The technique for defrauding the small investor

3.1 The classic description of the basic method generally used to cheat the small investor is given in the Oxford English Dictionary in relation to the nature of Ponzi schemes. Charles Ponzi perpetrated his activities in the United States immediately after the first World War. The type of swindle named after him is defined as follows:

> 'A form of fraud in which belief in the success of a fictive enterprise is fostered by payment of quick returns to first investors from money invested by others'

3.2 Ponzi's technique was to promise to pay 50% interest for the use of deposits for 45 days, based on a plan to arbitrage foreign exchange between actual depreciated exchange rates, together with International Postal Union coupons, to be bought abroad, and the higher fixed rates at which these coupons could be redeemed for U.S. stamps in the United States. The calculations were purely window dressing.

3.3 The scheme collapsed in August 1920, exactly 200 years after the collapse of the South Sea Bubble. When arrested it was discovered that although Ponzi had attracted over $7.9 million from the public he had no more than $61 worth of stamps and postal coupons to show for his efforts.

3.4 The rate of return offered by Ponzi was blatantly on the high side and deliberately calculated to take advantage of the greed of a gullible investor. The return offered by Clowes was not by contrast, as already seen, manifestly out of line with market rates and in this respect it was not only far more insidious than Ponzi's scheme but it was also by its nature such that the average small investor, let alone his professional adviser, might be hard pressed to perform the calculations to show that it was inherently unsound and dishonest.

Daniel Defoe's warnings

3.5 The vulnerability of the small investor is by no means a new phenomenon. Writing at the end of the seventeenth century when there was already a regular and reasonably sophisticated Stock Market in the City of London, Daniel Defoe in a paper entitled 'The Anatomy of Change Alley: a System of Stock-jobbing Proving that Scandalous Trade as it is now carried on to be Knavish in its Private Practice and Treason in its Public', stated:

> 'There is not a man but will own 'tis a complete System of Knavery; that 'tis a Trade in Fraud, born of Deceit and nourished by Trick, Cheat, Wheedle, Forgeries, Falsehoods and all sorts of Delusions'.

(See Rider, Chaikin and Abrams, *Guide to the Financial Services Act 1986* at paragraph 104).

3.6 The warnings of Defoe were not taken seriously enough and it is hardly surprising that some years later the South Sea Bubble crash took place with devastating results for many unwary investors.

3.7 For the next two hundred years or so the City was periodically rocked by financial scandals, but a low point was reached at the end of the nineteenth century. The exploitation and blatant abuse of the relatively new privilege of limited liability by a breed of sophisticated swindlers brought company law into a state of considerable disrepute. It was even claimed that Britain's company laws were among 'the least safe' for the investor of any in the civilised world and that creditors, as well as shareholders, were in urgent need of protection: *Spectator, 5th November 1898,* page 645, cited in Searle, *Corruption in British Politics, 1985 - 1930, Clarendon Press, 1987,* page 39.

The early roots of reform

3.8 The objective of successive enactments from the turn of the present century until the outbreak of the Second World War in the field of company and investment law can be seen as an attempt to make the general environment for investors more safe by providing for protection through various requirements, including a greater degree of disclosure of information in prospectuses and other public documentation, greater accountability on the part of company directors and by efforts to achieve more equal market conditions by the elimination of corrupt practices.

3.9 During the inter-war period new methods for taking advantage of the unwary investor arose in the shape of the door-to-door sale of company shares and the unregulated market concerned with the sale of unit trusts. The issues were debated by the Bodkin and Anderson Committees in Reports respectively published in 1936 and 1938: Cmnd 5259 and Cmnd 5539. Their recommendations were embodied in the Prevention of Fraud (Investments) Act 1939 (re-enacted by the Prevention of Fraud Investment Act 1958) which introduced a system of licensing, under the control of the Board of Trade, for individuals, firms and companies carrying on the business of dealing in securities.

3.10 The concept of dealing in securities was in substance defined as inducing any person to enter into:

(a) any agreement for, or with a view to, acquiring, disposing of, subscribing for or underwriting securities; or

(b) any agreement the purpose or pretended purpose of which was to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities, including shares or debentures in any company, U.K. or foreign government securities and unit trust schemes.

The continuation of the evil

3.11 Despite the tightening up of the legislation, the unsophisticated public continued to be persuaded to put their money into a variety of bogus, though superficially attractive, investments. A favourite was a scheme whereby the investor owned his own apple tree and the operator would make money for him through the sale of the fruit. Another was the pig investment scheme by which the operators induced individual members of the public to purchase pigs, which would become the property of the investor (and which he would be at liberty to visit during his leisure time), but which would be fed and cared for by the operator, the investor receiving financial returns out of the profits of breeding from the pigs: see Re Southern Livestock Producers Ltd. [1964] 1 WLR 24.

3.12 By 1980, as was revealed by the Commissioner of the City of London Police in his Annual Report for 1981, there had been a great explosion in the number of investment swindles and a realisation was growing regarding the inadequacy of the existing legislation for controlling the activities of companies in the business of handling funds on behalf of the investing public.

3.13 The Fraud Squad had been required to investigate the failure of a variety of investment companies whose financial difficulties, it was believed, could have been detected at a much earlier stage by a competent authority making standard supervisory checks, for example, examination of audited accounts. The Commissioner, in his report, observed that the problem was likely to remain until legislation, regulation and control were made more effective: see the Gower Report *Review of Investor Protection* (1984) at paragraph 1.13.

Gower and afterwards

3.14 The whole field regarding the regulatory and compensatory requirements for the protection of the small investor is again under review as a result of the Clucas Report referred to in the previous chapters.

3.15 In July 1981 Professor Gower was appointed by the Secretary of State for Trade to undertake a review with the following terms of reference:

> **(a)** to consider the statutory protection required by (i) private and (ii) business investors in securities and other property, including investors through unit trust and open-ended investment companies operating in the United Kingdom;
> **(b)** to consider the need for statutory control of dealers in securities investment consultants and investment managers;
> **(c)** to advise on the need for new legislation;
> **(d)** to take account in so doing of relevant developments in the European Community.

3.16 The Gower Report, presented to Parliament in January 1984, recommended the introduction of a system of regulation designed to achieve an adequate degree of investor protection. Professor Gower observed that there would inevitably be a tension between the need for such investor protection and market efficiency, often pulling in different directions. It might be that the most efficient market is wholly free from regulation, but it is unlikely that such a market would afford protection to investors which anyone today would regard as adequate. It is accordingly necessary to make a value judgment on the relative weight to be attached to market freedom.

3.17 Professor Gower reached the conclusion (paragraph 1.16) that:

> 'Regulation in the interests of investor protection should be no greater than is necessary to protect reasonable people from being made fools of.'

3.18 It was also recognised by Professor Gower that it would be useless to establish an effective system of domestic regulation if it could be undermined by concerns, established in other countries lacking equally effective regulation, which succeeded in marketing investments here in disregard of the domestic regulations. It is, with hindsight, ironic that these observations were being made, as the Ombudsman's Report into the Barlow Clowes affair reveals, at the very time that the off-shore activities of that group were getting fully into their stride.

3.19 The Financial Services Act 1986 was largely the product of the Gower report but its provisions did not, by and large, come into force until 1988. As already noted in paragraphs 1.23 and 3.14, the whole area regarding the regulatory and compensatory requirements for the protection of the small investor has again come under review as a result of the Clucas Report. The debate is, we believe, set to continue for some considerable time.

Chapter 4.

A DECADE OF DISASTERS

The 1980s.

4.1 During the last ten years or so there has been an ever-increasing volume of investment and other swindles involving growing numbers of the public and amounts sometimes of astronomic proportions. Several of these cases are described in this chapter in order to illustrate the range of problems and complexities that arise in such matters and the difficulties and delays faced by the small investor in recovering his funds or obtaining compensation.

The Ombudsman intervenes: Langford Scott

4.2 An early and significant example is that of Langford Scott and Partners Ltd. which had been granted a principal's licence under the Act of 1958 by the Department of Trade in 1980 and which, despite information internally available to the Department about the unsatisfactory nature of its activities, did not finally collapse until February 1983: see Rowan Bosworth-Davies, *Fraud in the City: Too good to be true (1987), The Bodley Head,* Chapter 5.

4.3 At a time when people on fixed incomes, such as non-index linked pensions, found that their incomes were becoming whittled away by the effects of inflation, the attraction of the Langford scheme was the opportunity for them to invest in areas where they would be able to maintain the level of their income. It was also imperative for them to find a means of investing in securities which would be safe, as the loss of their capital would represent a considerable threat to their livelihood.

4.4 The Langford system involved the investment of substantial lump sums of capital in local authority bonds, which, being offered by local authorities and maturing annually, were seen as a very safe form of investment generally carrying a good rate of interest.

4.5 At first Langfords bought the bonds through stockbrokers and sent the clients contract notes showing the bonds purchased on their behalf. The bonds themselves were not sent to them, the explanation given being that they would have to be surrendered when the time came to sell them and that they were better retained with Langfords for safe-custody.

4.6 The collapse of Langfords revealed that the funds of clients had, contrary to their expectations, been used in the main for highly speculative but unsuccessful investments.

4.7 The Ombudsman, at the suit of one investor who had entrusted his funds to Langfords during the last year of its existence, reviewed the actions of the Department of Trade in relation to the granting and renewal of its licence. The behaviour of the Department was described by the Ombudsman as 'surprising' and in some respects 'extraordinary' and the Department was criticised for 'their poor performance and for their apparent lack of regard for the protection of the public interest.' Dealing with the renewal of the licence in April 1982 the Ombudsman found that the Department had displayed:

> 'a lamentable lack of concern for the interests of those members of the public who, like Mr. Jones, had a right to assume that the Department's licensing system offered them a reasonable measure of protection for their investments'.

4.8 It was recommended that the Department pay compensation to Mr. Jones which he duly received.

Norton Warburg

4.9 The collapse in 1981 of Norton Warburg Holdings Ltd. which had solicited the deposit of investors' monies to be invested on their behalf, was the first of a long line of similar liquidations of which the demise of Dunsdale Investments Ltd. in June 1990 is no more than one of the more recent and notorious examples. The liquidation of Norton Warburg was prolonged for many years by a series of problems relating to the tracing of investors' funds as well as the application of the well-known rule in Clayton's case (1816) 1 Mer. 572. The nature of these problems is discussed in Norton Warburg Investments Management Ltd. v Gibbons and others, 31st July 1981, unreported, a decision of Dillon J., as he then was. The decision was recently referred to at some length by the Court of Appeal in Barlow Clowes International Ltd. v T.D.C. Vaughan on 12th July 1991. The Dunsdale case was referred to in various issues of *The Times* during June and July 1990: see para. 4.27 *infra.*

Exchange Securities and Commodities

4.10 In 1983 the activities of Keith Hunt gave rise to the winding-up of his group of companies on the petition of the Secretary of State. Hunt had invited deposits from the public for investments in commodities, commodity futures or for investment in unit trusts, insurance bonds and the like: Re Exchange Securities and Commodities Ltd [1983] BCLC 186 and Re Exchange Securities and Commodities Ltd (No.2) [1985] BCLC 392. Complex litigation took place in which some investors claimed that certain funds held by the companies were impressed with a trust for their benefit and were accordingly unavailable for the general body of creditors, including a large majority of other creditors. Problems of this nature have arisen in many of these subsequent cases and, until the publication of the Ombudsman's recommendations in December 1989, were of crucial concern in the Barlow Clowes affair.

Berkeley Applegate Investment Consultants

4.11 The problem also arose in the liquidation of Berkeley Applegate (Investment Consultants) Ltd which collapsed in 1987: see the three sets of proceedings reported under Re Berkeley Applegate (Investment Consultants) Ltd (1988) 4 BCC 274, and 279 and (1989) 5 BCC 803. In this case the company advertised quite widely in the national, local and religious press; it claimed to act as agent to place funds on behalf of individual investors and obtain first mortgages over freehold property. An individual investor would pay a sum he wished to invest to the company which would then lend the money to approved borrowers on mortgage, the mortgage being taken in the name of the company. The sums advanced to borrowers were generally in excess of the sums received from any one investor, so that the money advanced to any one borrower was generally derived from the investments of a number of distinct investors.

Walter L. Jacobs

4.12 In Re Walter L. Jacob & Co. Ltd. [1989] BCLC, 345 CA, a winding-up order was made on the petition of the Secretary of State for Trade and Industry as being in the public interest. The company was established in 1984 by a Scottish solicitor who was its sole director. Until April 1987 it carried on business as dealers in securities and investment advisers and had the requisite authority so to do by virtue of its membership of the self-regulating organisation known as Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA).

4.13 Until October 1986 the company's activities had been on a comparatively modest scale and it did not deal directly with the public. It then began to advertise nationally and offered to buy Trustee Savings Bank shares at a competitive price and without charging any commission. The advertisements were aimed at 'small investors'.

4.14 Persons who availed themselves of the offer (and there were many who did) were recommended, initially over the telephone by salesmen acting for the company, to consider investing in an American company. About one in every four agreed to do so and exchanged the whole of their investments in TSB for the American shares.

4.15 A few months later the company's business was further boosted as a result of similar advertisements regarding the British Gas issue. Altogether the company undertook over 5,000 separate purchase transactions of TSB and British Gas shares and gradually began to persuade its clients to switch to other American companies. The impression given to the clients was that the company was an adviser giving impartial advice whereas the truth was that the shares in the American companies were of doubtful value, could not be freely traded and were not unconnected with the company itself.

McDonald Wheeler Fund Management

4.16 In 1987 McDonald Wheeler Fund Management Ltd. collapsed. It had been run by John Wheeler and its business was that of financial advisers,

buying investments and insurance policies on behalf of clients; it also promoted funds of its own as a safe and profitable investment.

4.17 Wheeler had misappropriated substantial amounts of clients' money which had mostly gone into high risk companies set up by him, instead of being invested in low risk conservative investments as clients believed.

4.18 The price of the units in a fund promoted by the company had been falsely exaggerated to retain investors and to encourage new ones; it had been necessary to invent £4m. that did not exist to make up the shortfall between the real value of the funds and the £12m. advertised value.

4.19 In January 1990 Wheeler was given a sentence of eight years imprisonment and was disqualified for fifteen years from being a company director. He was told by the judge:

> 'You tricked hundreds of people into parting with their money by wholly bogus brochures and glib talk. Some were elderly and vulnerable. Some parted with their life savings.'

DPR Futures

4.20 In Re DPR Futures Ltd [1989] 1 WLR 778 the company had been incorporated in September 1986 with a nominal capital of £100,000 divided into 100,000 shares of £1. each, issued partly paid, only 17p being paid up on each £1 share.

4.21 In December 1986 the company began to trade as brokers in commodities and futures for private clients. It earned commissions on those transactions. It did not deal on its own account. A little more than a year later, in February 1988, one of the directors resigned and his shares, which had cost him no more than £6,000, were purchased by the company for nearly £600,000 and cancelled.

4.22 Prior to A - day in April 1987 when certain provisions of the Act of 1986 became operative, the company had several thousand investors; there were over 1,000 post A - day investors.

4.23 In July 1988 the SIB issued a notice of prohibition, bringing about a cessation of the company's business, and on the same day authorised an investigation into its affairs. The SIB also presented a winding-up petition on the grounds that the company's trading practices were contrary to the public interest and detrimental to its clients, and that it was unable to pay its debts.

4.24 A winding-up order was made against the company in October 1988 and in January 1989 several of its directors were arrested and charged with conspiracy to defraud and breaches of section 330 of the Companies Act 1985, prohibiting the making of loans to directors; they were acquitted in July 1990.

4.25 The joint liquidators commenced proceedings against the directors for misfeasance and to recover approximately £2.3m. withdrawn in the form of directors' emoluments, dividends, loans and £600,000 paid for the shares. Although the issues in the civil and criminal proceedings were not identical there was a substantial overlap between them, both requiring a detailed consideration of the manner in which the company's business was conducted and of the responsibility of each of the directors for its activities. Since those investigations would be bound to attract widespread publicity in the media, a real risk of prejudice existed to the right of the directors to a fair trial if the civil proceedings were heard before the criminal proceedings, particularly if shortly beforehand.

4.26 The case was not, however, sufficiently strong to justify a total stay of the civil proceedings. As Millett J. pointed out:

> 'Until they are concluded many hundreds and possibly thousands of small investors have no chance of recovering the money which they have lost. Once the criminal proceedings have been concluded the sooner the joint liquidators' claim can be heard the better.'

Dunsdale, Kentascot *et al*

4.27 The disasters continue to happen with almost monotonous regularity. In March 1990 Money Management Financial Services Ltd collapsed, the victims having lost money in 'broker bonds' managed by the company: *The Times,* 12th March 1990. In June 1990 Dunsdale Securities Ltd. collapsed, there being no apparent sign of the bonds in which the victims believed their money had been invested: *The Times,* 18th July 1990. In July 1990 Kentascot collapsed, in circumstances where investors appear to have believed that their funds were invested in bonds off-shore but amidst concern of investments in South African companies: *The Times,* 18th July 1990.

Hardship to the investor.

4.28 The misery and mental anguish caused to the innocent victims of so many disasters is incalculable, not to speak of the financial loss sustained by each of them and their families. The overwhelming majority of such investors must be regarded, in the words of Professor Gower, as 'reasonable people' and any suggestion that their investments were made imprudently must surely be dismissed. There is no doubt that such people have been made fools of and the omens are that more innocent people will find themselves in a similar predicament during the next decade, unless there is a determined effort by all the regulatory and other authorities to wage war to stamp out the evil.

4.29 Thus, as we pointed out in paragraph 3.14,the evil continues to exist, albeit the absence of any spectacular collapses in the last twelve months or so may indicate that the regulatory regime under the Financial Services Act 1986 has begun to curtail the mischief. If, as we hope, there is any real cause for satisfaction in the area of protection for the small investor, the same cannot be said as regards the parallel field of protection for pension schemes, as already mentioned in paragraph 1.22. It is a matter of regret and concern that the clear recommendations by Professor Gower and others for statutory regulation of such schemes have for so long been ignored: see paragraph 1.22.

4.30 As pensions are the most important asset apart from housing in which people have a stake, one might expect this area of investment to be tightly regulated. However, as Professor Gower has wryly noted more than once:

> 'Such, however, is not the case. Of all investments it is, perhaps, the least regulated. There is no specific statutory regime for pension funds; they depend simply on the law of trusts'.

4.31 Our concern, however, has been limited to the field of the small investor and in the following chapters we consider some of the minimum requirements we identified in paragraph 2.29 for his protection. Our discussion of these matters must, of course, be read in conjunction with what is said in paragraph 1.12 regarding the need for a proper degree of vigilance on the part of the small investor himself based upon at least an elementary programme of education regarding the handling of savings and investments.

Chapter 5.

PROTECTION THROUGH A GUARANTEE FUND AND THE ROLE OF THE OMBUDSMAN

Compensation

5.1 The ideal solution for the small investor would be the existence of a comprehensive guarantee fund provided by the investment industry as a whole capable of making good promptly and to the fullest financial extent losses genuinely attributable to dishonesty. This thus identifies two of our minimum requirements: first the need for an effective compensation fund and secondly the need for prompt and speedy relief, a familiar cry of all litigants and claimants. The reality is, of course, quite different.

5.2 We consider first the requirement for an effective compensation fund. We examine in the remainder of this chapter the history of compensation schemes in analogous areas and also the assistance provided by an Ombudsman system in obtaining compensation for victims. In the following chapter we examine the compensation scheme established under the Financial Services Act 1986.

5.3 Before the implementation of the Financial Services Act 1986, the amount of assistance available to defrauded small investors or the victims of dishonesty by professional firms through the safety-net of a compensation scheme was extremely limited. The Law Society, as will be seen, provided a compensation fund in respect of dishonesty by solicitors and other professional bodies followed suit with similar schemes. By the Policyholders Protection Act 1975 provisions exist for alleviating loss upon the collapse of an insurance company. Provisions of a limited nature exist to protect depositors of a failed bank or building society and the Stock Exchange maintained (but no longer does so) a scheme to assist clients of a hammered member.

Law Society

5.4 The origins of the Law Society's compensation scheme, now regulated by the Solicitors' Act 1974, provide a remarkable illustration of a profession struggling for over forty years to find a way to make good losses sustained by clients through the dishonesty of its members. The approach of the Law Society to the problem can certainly be regarded as a springboard from which the more general provisions for compensation in the financial services industry under the Act of 1986 derived.

5.5 At the turn of the century public confidence was somewhat shaken by the frequency and scale of bankruptcies amongst solicitors, including a number of well-known firms. One of the offenders, a Past-President of the Law Society, had been sent to prison where he became the Governor's butler.

5.6 The work of solicitors offered special temptations to fraud. The management of landed estates, trusts and settlements and the general handling of money belonging to clients provided opportunities to speculate with clients' money without their knowledge. Inevitably the profession contained a certain number of persons who yielded to these temptations.

5.7 The Law Society attempted to put its own house in order both to save the public from fraudulent solicitors and to save solicitors from losing trustee business. A Committee was appointed in 1900 to investigate what steps could be taken to prevent frauds. Under the existing law, misappropriation of funds was not a criminal offence unless the client had earmarked them for a particular purpose. The committee recommended that the law should be changed and the Law Society promoted the Larceny Act 1901 which made fraudulent conversion of any funds held by an agent a criminal offence.

5.8 The level of bankruptcies amongst solicitors remained high and it became increasingly clear that the root of the problem lay in the haphazard manner in which many solicitors kept their accounts. Double-entry book-keeping was little used and current text books did not yet recommend separate bank accounts for clients' money. In 1907 yet another committee of the Law Society was set up, this time to look into the whole question of accounts and also the formation of a guarantee fund to protect the clients of those who had defaulted.

5.9 The problem did not go away and, as the economy picked up after the first World War, there was once again an increase in the number of solicitors becoming bankrupt. It was generally felt that some means had to be found to prevent solicitors from making illegitimate use of their clients' money and to make good any loss sustained by the clients arising out of the fraud or bankruptcy of a solicitor.

5.10 In 1930 the Law Society suggested three remedies, the first being that membership of the Society should be compulsory and the second that separate accounts should be kept for clients' money. The third proposal was that solicitors as a whole should make good any losses falling on clients by defaulters.

5.11 When the Solicitors' Accounts Rules came into force in 1935, it was discovered that those solicitors who ended up by defrauding their clients usually owed their troubles to badly kept accounts. Having got into a muddle, they resorted to fraud in an attempt to extricate themselves. The appalling muddles which came to the notice of the Law Society, coupled with a larger than usual number of frauds during 1938, caused the Society to seek further powers over its members which were embodied in the Solicitors' Act 1941.

5.12 Solicitors were required under the Act, as is still the case, to produce an auditor's certificate of their accounts when applying for their annual practising certificate. The Act also set up a compensation fund to which every practising solicitor had to contribute up to £5. per year: See Brian Abel-Smith and Robert Stevens, *Lawyers and the Courts,* pages 188-190 and Birks, *Gentlemen of the Law,* page 273.

5.13 The maintenance and administration of the compensation fund are now governed by section 36 of the Solicitors' Act 1974. The Council of the Law Society may make a grant out of the fund for the purpose of relieving loss or hardship where it is satisfied:

> that a person has suffered, or is likely to suffer, loss in consequence of dishonesty on the part of a solicitor or of an employee of a solicitor in connection with the solicitor's practice or purported practice or in connection with any trust of which that solicitor is or has been a trustee;
>
> that a person has suffered or is likely to suffer hardship in consequence of failure on the part of a solicitor to account for money which has come to his hands in connection with his practice or purported practice or in connection with any trust of which he has been a trustee.

5.14 The making of a grant is entirely discretionary. Where a grant is made otherwise than by way of loan or is made by way of a loan which has been in whole or in part waived or which the borrower has failed to repay in full or in part, the Law Society is then subrogated to any rights and remedies of the person to whom the grant is made in relation to the act or default in respect of which it is made, and is entitled, upon giving him a sufficient indemnity against costs, to require him, whether before or after payment of the grant, to sue in his own name but on behalf of the Society for the purpose of giving effect to the Society's rights, and to permit the Society to have the conduct of the proceedings.

Eichholz

5.15 An early and spectacular disaster, which severely crippled the compensation fund, arose out of the affairs of Robert Eichholz who died hopelessly insolvent in 1957. Numerous clients entered claims against the Society to be indemnified against misappropriation by him of monies with which he had been entrusted as a solicitor; the misappropriations ultimately amounted to well over £500,000. In 1954, at the time of his second marriage, the claims already amounted to £171,000, the assets being no more than £21,000, and for the remainder of his life the misappropriations continued on an ever-increasing scale: Re Eichholz decd. [1959] Ch. 708.

Alternative approaches

5.16 In the absence of any equivalent compensation scheme to cover the financial industry generally, defrauded investors were driven to explore other

avenues for the recovery of their losses from solvent parties. It accordingly became fashionable to pursue the following routes:

> (i) to sue the appropriate regulatory authority for negligence in failing adequately to supervise the defaulter;
> (ii) to invite the Ombudsman to make a finding of maladministration where the regulatory authority was the Department of Trade and Industry, followed by a recommendation for recompense to defrauded investors.

5.17 In Yuen Kun Yeu v Attorney-General of Hong Kong [1988] A.C. 175, the plaintiffs brought an action for damages for negligence against the Attorney General of Hong Kong representing the Commissioner of Deposit-taking Companies, in circumstances where he had registered a company as a deposit-taking company which had subsequently gone into liquidation. The plaintiffs, having lost monies deposited with the company, alleged that they had made the deposits in reliance upon the company's registration and that the Commissioner knew, or ought to have known had he taken reasonable care, that the company's affairs were being conducted fraudulently, speculatively and to the detriment of its depositors and that in the circumstances he should have revoked its registration before the plaintiffs made their deposits. The Privy Council upheld a decision to strike out the claim as disclosing no reasonable cause of action on the grounds that the Commissioner, performing a duty in the public interest, owed no responsibility towards an indeterminate number of individual potential depositors.

5.18 In Davis v Radcliffe [1990] 1WLR 821 an unsuccessful attempt was made by depositors to sue the banking regulatory authorities in the Isle of Man for failure adequately to supervise the affairs of the Savings and Investment Bank Ltd. which had collapsed in 1982 in hopelessly insolvent circumstances. The striking out of the claim was upheld by the Privy Council, the case being almost indistinguishable from that of Yuen Kun Yeu v A-G. of Hong Kong.

The Ombudsman: Barlow Clowes

5.19 A complaint to the Ombudsman proved to be a far more promising route as the Langford Scott case demonstrated. This was the course adopted by investors in the Barlow Clowes affair which led to a finding of maladministration and a recommendation which in substance returned to the overwhelming number of investors a very substantial amount of their funds, supplemented by compound interest.

5.20 The basis for calculating payments to investors was as follows (see paragraphs 8.19 - 8.21 of the Ombudsman's Report):

> **(a)** a calculation was to be made of the basic claim attributable to each investor at the date of the liquidation of the relevant Barlow Clowes company. This calculation would take into account not only the amount originally invested but also interest which would have been earned had

the amount invested been deposited and earned compound interest in a long-term U.K. deposit account.

(b) the amounts thus calculated would then be abated on the following basis:

where the basic claim as calculated was not greater than £50,000 it would be abated by 10%;

where the basic claim was greater than £50,000 but not greater than £100,000 the first £50,000 would be abated by 10% and the remainder would be abated by 20%;

where the basic claim was over £100,000 the first £50,000 would be abated by 10%, the next £50,000 by 20% and the remainder by 40%;

(c) the amount to be paid would then be calculated by applying compound interest (up to the end of 1989) at an appropriate rate to the abated sum thus calculated, taking account of the interest which investors could have earned on sums which had already been paid in the liquidation of the relevant companies or by third parties. This would give a gross figure, from which would be deducted the amounts already paid to investors in the liquidation or by third parties to give the total amount to be paid.

The reasons why the government proposed that the claims should abate in this way and which the Ombudsman found to be not without foundation were as follows.

5.21 It was considered important for investors to understand that no investment is entirely free of all risk, and that investors must be expected to bear part of the risk themselves:

Investors who have large sums at their disposal might also be expected to be better placed to take proper care before committing their funds, and should accept a greater degree of responsibility for the consequences of their own decisions; the payment to them should reflect this;

It was also proposed by the government and accepted by the Ombudsman that the government should have the discretion to withhold payment from any person who appeared to have contributed to, or to have benefited directly or indirectly from, the circumstances leading up to the collapse.

5.22 The Ombudsman considered that it was not unsatisfactory that those with investments of £50,000 or less should end up having received 90% - and those with investments of up to £100,000 at least 85% - of their capital and, in addition, compensation in the form of interest for loss of income on that amount since the collapse. It was understood that investors with £100,000 or less invested constituted over 99.5% of the number of investors involved.

5.23 As to the larger investors, the recommendations left them with a greater percentage loss but the Ombudsman considered for the reasons mentioned above that this was not unreasonable.

5.24 Apart from the satisfactory outcome of the intervention of the Ombudsman for the investors in the Barlow Clowes affair, it was also a matter of immense practical importance that his investigation into the regulatory role of the Department of Trade and Industry could be carried out at no expense to the investors. The investigation was also a matter of considerable public importance by virtue of what was revealed regarding the unsatisfactory nature of the inner-most workings of the Department's regulatory activities.

Chapter 6

THE IMPACT OF THE FINANCIAL SERVICES ACT

No scope for intervention by the Ombudsman

6.1 With the removal by the Financial Services Act of much of the responsibility in the regulatory field from the shoulders of the Department of Trade and Industry, the route of a complaint to the Ombudsman will no longer be available and, if a Barlow Clowes type of situation arose in the future, defrauded investors would no longer have at their disposal such a powerful weapon for making good their losses. It is now envisaged by the government that the residue of the Department's responsibilities will be transferred to H.M. Treasury.

6.2 We view the removal of this route of complaint (i.e. to an Ombudsman) under the Financial Services regime with considerable disquiet and consider that the industry should provide one or more means of recourse to an independent body or person with effective and well publicised powers to make prompt and swift awards from an established fund or against regulatory bodies in cases of collapse. When we were originally considering the problem it assumed increasing importance in the light of proposals for replacing the existing compensation scheme (which we examine in the next chapter) with a regulatory wealth warning to the effect that money should not be placed with advisers who are not legally entitled to handle it: (see *Financial Times,* 16th October 1990).

6.3 The detailed proposals in the Clucas report for the creation of a new SRO to regulate investment business primarily done with or directly for the private investor would go a considerable way to meet the problem. The proposed new self-regulatory organisation for retail investment business is to be named The Personal Investment Authority (P.I.A.): See *Financial Times,* 21st May 1992.

6.4 If the new SRO envisaged by Clucas were to be established there would under the new set-up be three SROs instead of four:

(A) For the private investor
(i) The new SRO;

(B) For the professional investor
(ii) IMRO - Fund Management.
(iii) SFA - Exchange related activities.

6.5 We draw attention in para. 7.9 to our own bewilderment at the sheer immensity and daunting nature of the existing system of investor protection. The proposal therefore for rationalisation and simplification must therefore be welcomed.

The consumer interest under the proposed three SRO system.

6.6 The governing body of the new private investor SRO would be constituted so as to provide a proper balance between the interests of the various types of firms within the scope of the SRO and the interests of the public. It is proposed that the governing body would consist of a Chairman and 24 members allocated as follows:

Product providers (between life offices, friendly societies, unit trust managers and other such providers)	
Managers of investment trust saving schemes	10
Independent practitioners	8
Public interest	6

6.7 The role of the public interest members is regarded as crucial, as they will effectively hold the balance between the two main groups. It is, however, intended that the governing body will be a single unit with all its members individually taking part in its work and sharing responsibility for its decisions.

6.8 It will be the responsibility of all members of the governing body to safeguard the interests of consumers, for that is what the new SRO will exist to do. A particular responsibility will nonetheless rest on members appointed to represent the public interest, though it is not envisaged that these would be confined to individuals with active experience in the consumer field. The public interest members should rather be appointed from among people whose experience outside the industry, whether in public life, the professions, business or consumer organisations, will enable them to assist in the operation of an organisation which efficiently and effectively carries out its role of protecting the investor.

6.9 The public interest members will accordingly, it is envisaged, always be conscious of the interests of consumers. But, by being actively involved in the direction and operation of the new SRO, they will share with their practitioner colleagues an interest in seeing that the organisation actually works. Though this would be in the interest of investors, their active involvement might slightly blur the degree of objectivity which the public interest members can apply to their assessment of the SRO's work.

The proposed new consumers' forum

6.10 It is considered desirable to overcome any such lack of objectivity that a forum should be established outside the SRO itself in which the SRO's policies can be submitted to scrutiny from the consumer's point of view.

6.11 Both LAUTRO and FIMBRA (see para. 7.4 for definitions) have established arrangements for informal consultation with consumer groups. The Clucas Report considers that there is a need for these to be formalised through the appointment, by the new SRO, of a small consumer panel which would have the right to enquire about, and be consulted on, its policies.

6.12 It would, in the view of Clucas, be particularly appropriate (and indeed helpful to the new SRO itself) if the proposed forum or panel could include in its membership individuals with experience in the handling of consumer complaints. It is envisaged that the panel would be given a budget which would enable it to undertake its own research or, at the very least, would know that any request it made for research to be undertaken on its behalf would not be unreasonably refused.

6.13 While the proposal for the creation of a new private investor SRO is in general to be welcomed, the detailed proposals regarding a proposed new consumers' forum or panel seemed to us to be extremely weak and unsatisfactory in that the members of the forum are not independent of the SRO and will be subject to a dual allegiance.

Rationalisation of Ombudsman Schemes

6.14 There is, as matters presently stand, some considerable confusion regarding the nature and role of a variety of Ombudsmen. Some SROs, for example, have taken steps to appoint their own form of Ombudsman: IMRO has appointed the Investment Ombudsman. Entirely outside the regime of the Act of 1986 a Unit Trust Ombudsman has been appointed along with an Insurance Ombudsman, although they have now merged. FIMBRA on the other hand has withdrawn from what is now the Investment Ombudsman scheme and operates instead a Consumer's Arbitration scheme. A more detailed discussion of the proliferation of private sector Ombudsman schemes is contained in the recent JUSTICE report *Justice and the Individual* in paragraphs 4.33 - 4.50.

Compensation

6.15 So far as concerns the future the compensation scheme established under the Act of 1986, to which reference is made in the next chapter, will have a critical role to play in alleviating losses caused to the private investor and it is likely to become in practice a significant source of recovery. We viewed with considerable concern press reports that existing compensation schemes are causing hardship to investors (*The Independent,* 9th February 1991) or to FIMBRA (*The Independent,* 13th February 1991) or are giving rise to 'bureaucratic wranglings' (*The Times,* 12th February 1991). We still consider that whatever compensation scheme is in force (and maybe it ought to have state backing) it must be speedy and effective. The creation of a new private investor SRO would provide the springboard for such a system.

Simplification of complaints procedures

6.16 The need for rationalisation of the complaints procedures is clearly recognized by the Clucas Report. The way in which complaints are handled is important on three counts:

> **(i)** to give investors the opportunity of an explanation in respect of conduct they do not understand and satisfaction when their complaint is justified;
> **(ii)** to enable infractions to be identified and timely steps, including possible suspension or disciplinary action, to be taken to safeguard the interests of other investors;
> **(iii)** as a management tool to help the governing body of an SRO to assess the efficiency and effectiveness of its operations.

6.17 At present the various SROs have differed in the arrangements they have made. FIMBRA, for example, has appointed a Commissioner to handle complaints against itself and to oversee the way in which complaints against member firms are handled. Complainants who cannot reach agreement with a member are encouraged to submit their case to arbitration which is provided, at FIMBRA's expense, under arrangements made with the Chartered Institute of Arbitrators.

6.18 On the other hand IMRO arranges for complaints to be handled in-house with the possibility of these being passed, if unresolved, to an Investment Ombudsman for conciliation or arbitration.

6.19 LAUTRO by contrast has sub-contracted the bulk of its complaints handling to the Insurance Ombudsman Bureau, a voluntary organisation to which most of its members belong. Complaints in respect of other firms are handled by LAUTRO itself.

6.20 With the creation of a new private investor SRO there is scope for rationalisation. The Clucas Report considers that this does not necessarily mean that all complaints should be handled in the same way but rather that this is an area where a degree of specialisation on the part of the complaints handler can be useful.

6.21 We agree with Clucas that it is essential that there should be one central point to which all complaints about equity investment by individuals can be made. It would then be the responsibility of the SRO, and not of the individual member of the public, to decide the correct destination for a complaint and to make sure it gets there.

Chapter 7

THE SAFETY-NET OF THE INVESTORS COMPENSATION SCHEME

The present regulatory arrangements

7.1 When the Financial Services Act 1986 finally came into full force in April 1988 it was estimated that there were well over 36,000 businesses engaged in some form or other of investment activity and personal financial planning with which the small investor might be concerned. These activities will include a wide variety of matters such as dealing in or advising on life assurance, unit trusts and investment-linked pensions, stocks and shares and commodity and financial futures and options.

7.2 It is a fundamental part of the new system that those engaged in such activities must be 'authorised' and authorisation will indicate that they have been recognised, by the appropriate body, to be honest, solvent and competent to advise or act for the investor. More specifically it is expressly provided by the Financial Services (Conduct of Business) Rules that a person authorised to carry on investment business must:

(i) observe high standards of integrity and fair dealing in the conduct of investment business and comply with best market practice,

(ii) act with due skill, care and diligence in providing any service which he provides or holds himself out as willing to provide, and

(iii) deal fairly with his customers in any transaction entered into or arranged to be entered into with them or on their behalf.

7.3 If rigorously enforced we consider these principles ought, in theory, to meet one of the minimum requirements we identified in para. 2.29 above for the protection of the small investor, namely the requirement for access to sound, reliable, expert advice.

7.4 The most numerous and most important category of persons who are authorised to carry on investment business are members of self-regulating organisations (SROs) recognised by the Securities and Investment Board, sometimes itself referred to as 'The regulator of regulators'. At present after certain rearrangements these recognised self-regulating organisations comprise:

The Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA)

The Investment Management Regulatory Organisation (IMRO)

The Life Assurance and Unit Trust Regulatory Organisation (LAUTRO)

Securities and Futures Authority (SFA)

7.5 There are three complaints handling bodies:

Complaints Commissioner (SIB, FIMBRA, SFA)

The Investment Referee (IMRO)

Insurance Ombudsman Bureau.

7.6 There are also nine recognised professional bodies (RPBs) covering the legal, accountancy, actuarial and insurance brokers professions.

7.7 At the beginning of February 1992 there was a total of approximately 30,000 authorised persons, two-thirds certified by their professional bodies and one-third by SROs: FIMBRA 6,724, LAUTRO 646, IMRO 1,245 and SFA 1,374.

7.8 FIMBRA. as its name implies, covers intermediaries, managers and brokers. As such it is a widely-based SRO, with a range of membership from large firms carrying on a number of specialist investment business activities, including portfolio management, to one-man firms acting as advisers on pooled products only. There has been a sharp decline in the membership of FIMBRA for a number of reasons and it has been indicated by representatives of both life offices and unit trust companies that they will not be prepared to continue to meet FIMBRA members' compensation liabilities without being able to satisfy themselves that FIMBRA's monitoring and enforcement capability is of a sufficient standard to minimise the incidence of compensation claims.

7.9 Whilst we recognise that the process of authorisation may have eliminated about 6,000 businesses hitherto engaged in the financial services industry (on the basis that these have either been refused authorisation or have withdrawn applications for authorisation) we remain concerned about the number and divergency of so many bodies and organisations in the regulatory field. To the small investor they convey little if anything other than a meaningless acronym representing a quasi-official bureaucratic body existing in, and possibly even belonging to, LIMBO. The small investor is clearly intended to derive comfort from the notion that if he or she deals with a member of such a body that member ought in some way to be 'guaranteed'. But this is no comfort if either the rules of the relevant body are impossible to discern or understand, still less if it then appears that there is no real or effective 'guarantee' behind the acronym. At the end of the day to the small investor that 'guarantee' must be a financial one, i.e. if he or she becomes a victim of a defaulting member of a regulatory body there will be reasonable and swift compensation. It is this we now examine.

The purpose of the compensation scheme

7.10 Despite the haphazard manner in which the present somewhat confusing arrangements for a compensation scheme have evolved, they can be seen as reflecting specific and well understood needs. The reasoning behind payment of compensation to individual investors may, as pointed out in para. 2.11 of the Clucas Report, be summarised as:

(a) the purpose of regulation is to protect the investor by prescribing and enforcing standards of status and behaviour;
(b) inevitably there will be instances where defaults arise despite the regulatory system, whether from, for example, business failures or fraud;
(c) there must therefore be arrangements for compensating, to some degree, investors who under such circumstances incur losses for which they are not to blame.

7.11 Under the old system a very limited number of investment transactions were covered by compensation arrangements, but an extremely large number were not, leaving investors vulnerable to loss if the particular firm handling their transaction defaulted; the Stock Exchange's discretionary compensation scheme was abolished on the arrival of the Act of 1986. For the first time, under the provisions of the Act of 1986, a scheme has been created in the United Kingdom which, with very few exceptions, gives all individuals the same degree of cover for investment within the scope of the Act.

7.12 The purpose of the scheme is to provide protection for the small investor. The knowledge of its existence, however, is also calculated to reduce the long-term impact of failures on the part of authorised firms on the general confidence in the financial services industry with corresponding benefit to all authorised businesses.

7.13 The existence of the scheme and indeed the protection provided by the Act generally cannot relieve investors of the responsibility to take care when investing their money. The scheme is not designed to replace basic commonsense or the need for vigilance, as we have stressed in paragraph 1.12. It provides only a limited amount of protection, it does not provide compensation for losses arising from poor decisions by the investor but it is focused especially on small investors who are less able to protect their own interests and who are hit relatively hard by the failure of an authorised firm: see para. 2.3 of the SIB's Review of the Investors Compensation Scheme (Consultative Paper No.28), issued in August 1989.

The compensation scheme as a safety-net.

7.14 The Investors Compensation Scheme (ICS) was set up under section 54 of the Act of 1986. The scheme is designed to compensate investors where members or former members of an SRO 'are unable, or likely to be unable, to satisfy claims in respect of any description of civil liability incurred by them in connection with their investment businesses'. Inability to satisfy the claims can arise for reasons ranging from business failure, through business failure related to theft or fraud.

7.15 Since the scheme began in August 1988 the ICS has (at the end of February 1992) declared 44 firms to be in default. Of these 33 involved FIMBRA members and approximately 30% of this group involved FIMBRA members who were not authorised to handle client money.

7.16 The scheme is funded by a levy on members and between 1988 and 1991 the total so raised was £13,838,548 of which £8,164,711 was allocated to FIMBRA. Figures are not yet available for the year 1991/92: see Appendix 4 to the Clucas Report.

7.17 Furthermore each RPB is required by the SIB to have compensation arrangements which would ensure that, in the case of a default by an RPB firm, an investor receives no less favourable treatment than under the ICS. The present position is set out in paragraph 14 of Appendix 3 to the Clucas Report as follows:

	Overall Limit	**Limit per Claim**
Institute of Chartered Accountants	£10 million	£50,000 in England and Wales, Scotland and joint scheme Ireland
Law Societies of England, Scotland and Northern Ireland	no limit	no limit
The Chartered Association of Certified Accountants (ACCA)	£1 million	£48,000
Insurance Brokers Registration Council (IBRC)	no limit	no limit
Institute of Actuaries (IOA)	£1 million	£48,000

7.18 In broad terms those who place their money with authorised firms after 27th August 1988 have protection which covers up to £48,000 of their investment if their firm defaults. This has been described as 'the safety-net' underlying the whole investor protection structure: see the SIB's explanatory guide to the Investors Compensation Scheme issued in 1988.

7.19 Where an investor's money has been invested by an authorised firm acting as an 'intermediary' - that is, in a form of investment such as shares or unit trusts which are independent of the firm itself and where the investor is actually registered as the owner - his funds may not be at all affected by the intermediary going into default. If, however, the firm collapsed while holding money not yet invested or if the investor's money was being managed for him with no such independent investments to which he had clear title or where the investor's money was mixed with the intermediary's own or other investors monies, the situation could be very different indeed.

7.20 In the case of money held on the investor's behalf, the framework of the new system requires that all funds held for private investors must be kept in strictly segregated accounts and should accordingly be easy to identify as the investor's property and not that of the firm in the event of its insolvency. As

long as those requirements have been properly observed, money so held should be capable of being returned to the investor as soon as its ownership has been determined.

7.21 The 'safety-net' of the compensation scheme comes into play insofar as those requirements have not been observed and the funds of the investor are no longer specifically available or capable of being traced. The scheme has been established under the auspices of the SIB, is conducted by a Management Company and is financed by a general levy on participating members in the financial services industry.

7.22 The Scheme provides for the payment of compensation to investors in cases where persons or firms who are or have been authorised to carry on investment business are unable, or likely to be unable, to satisfy claims in respect of civil liability of any description (whether arising under the Financial Services Act or at common law or in equity) incurred by them in connection with carrying on investment business. The entitlement to compensation will accordingly arise in respect of any failure to account for property, investments or money held in connection with investment business and may also extend to a situation where the investor, perhaps through receiving proven incompetent or biased advice, has suffered loss from the actions of an authorised business which has gone into liquidation.

7.23 The Scheme is not retrospective. It covers investment business conducted by authorised firms within its ambit on or after 28th August, 1988, when the Scheme came into operation. It has been established in proceedings commenced by the SIB that the compensation rules do not make FIMBRA liable for losses incurred prior to this date: SIB v FIMBRA [1991] 3 WLR 889.

7.24 Investors may be eligible for compensation of up to £48,000, made up of 100% of the first £30,000 of eligible loss and 90% of the second £20,000 of such loss. Although the Scheme has very substantial funding behind it, it is not unlimited, and if compensation costs in a year exceed £100m., the payments to claimants will need to be scaled down. In any particularly heavy year for claims there may have to be the equivalent of a moratorium on payments.

7.25 The scheme is not entirely comprehensive and there are a number of exclusions from eligibility for compensation including:

(i) professional advisers;

(ii) business investors or experienced investors insofar as their claims relate to money maintained with their consent outside the segregation arrangements;

(iii) any investor with contributory responsibility for the default.

7.26 The Scheme covers authorised firms only. Business with those which merely have 'interim authorised' status (i.e. firms which have applied for authorisation but have not yet had the application processed) is not covered. Such firms are required to make their standing clear on stationery and in advertisements.

7.27 There are other categories of business not covered by the Scheme. The Deposit Protection Scheme for banks and the Building Societies Scheme provide compensation at a rate of 75% and 90% respectively of eligible loss up to £20,000. The Policyholders Protection Act 1975 provides 90% of contractual benefits (which may not be the same as the face value of the claim) and the Lloyds Scheme (otherwise similar to the investors compensation scheme) provides a lower percentage cover at higher levels of loss. In addition it is understood that, insofar as there are equivalent European Community schemes, they provide less than 100% cover. As a matter of history, the Stock Exchange Scheme (no longer in existence) gave greater cover, but was focused on a particular type of transaction and was therefore much narrower in scope: see paragraph 9.2 of the SIB's Review Working Paper. Finally, of course, members of recognised professional bodies such as solicitors and accountants continue to have their own individual schemes.

7.28 It is worth noting that far higher levels of compensation can be awarded by the Insurance Ombudsman, who has the power to award up to £100,000 against a member company. Power to award similar levels of compensation is held by both the Banking Ombudsman and the Investment Ombudsman. While we accept that the prospects of Bank or Building Society depositors in the United Kingdom suffering loss is far lower than in other countries (for example, the United States of America) we believe that in the financial services sector these higher levels of compensation are only realistic, given the very considerable amounts of wealth which quite ordinary people can receive, for example, either through inheritance or through redundancy. We are not convinced that SIB's present limit of £48,000 can be justified, notwithstanding inflation, on the basis that it was too high to start with: see *Minutes of Evidence, House of Commons Trade & Industry Committee,* 19th December 1990, p.13.

7.29 The new arrangements, it must be stressed, give no protection to investors from loss in relation to investment businesses which are unauthorised, either by virtue of being based wholly outside the jurisdiction of the United Kingdom or because they are operating illegally within the United Kingdom. It is for this reason that if an investor has any doubt about the status of an investment firm he should in his own interests check it out immediately. A register of authorised and interim authorised businesses is maintained by the SIB for this purpose and can be checked either by a special telephone number or through the Prestel Computer Database (which may be available to home or office computer users and in many libraries).

The funding of the Compensation Scheme

7.30 The Act of 1986 requires that, as far as practicable, the cost of meeting compensation claims arising out of the default of an SRO member should fall on the other members of that SRO. The rules of the Investors Compensation Scheme give effect to this requirement but place upper limits on the amounts the members of each SRO are liable to meet. For 1991/92 the limits are:

FIMBRA	£19 million
LAUTRO	£27 million
IMRO	£18 million
SFA	£51 million
SIB	£5 million

Once any of those limits is reached the excess above it falls to be recovered from the membership of SROs as a whole, up to the overall scheme limit of £100 million. New contribution limits for the SROs are expected to be agreed and published shortly.

7.31 Although the professional bodies might in theory choose to participate in the Investors Compensation Scheme, they have all in practice chosen either to set up separate schemes or to use existing arrangements within the professional body.

7.32 The funding of the Investors Compensation Scheme itself has been bedevilled by the ambivalent attitude within the financial services industry as a whole towards FIMBRA, whose monitoring and enforcement capability is, rightly or wrongly, regarded by the financial services industry as not being of a sufficient standard to minimise the incidence of compensation claims. The likelihood that there will be a restructuring of the boundaries covered by the various SROs and FIMBRA in particular will inevitably involve a reassessment of how the compensation burden is to be borne across the whole of the financial services industry. The proposal by the Clucas Report for the creation of a new private investor SRO will at the same time focus attention on the vexed problem of finding a generally acceptable and satisfactory solution to the problem of funding the compensation scheme.

European Community

7.33 The situation regarding compensation in relation to investment businesses conducted within the area of the European Community has not yet been finally established. Under current proposals, a firm authorised in its home state will have a passport to do business throughout the community subject to obeying conduct of business rules of the host state. It is envisaged that responsibility for compensation schemes will be divided between home and host states. By and large a company operating through a branch in the U.K. would have to belong to the U.K. compensation scheme, but an investor doing business with a company established elsewhere in the community, and operating on a services basis will have recourse to any scheme of that company's home state: see paragraph 11.1 on the SIB's Review Working Paper.

The scheme in practice

7.34 Some evidence has emerged regarding the workings of the Scheme (see paragraph 4. of the SIB's Review Working Paper):

(i) Allied Equity Ltd., a company authorised by IMRO to act as a discretionary fund manager, was determined in default on 28th November 1988; compensation totalling £270,664 was paid to 54 investors on 31st March 1989;

(ii) Another four authorised companies were determined in default up to 31st July 1989:

E.J. Collins & Co. Ltd. (TSA) an agency stockbroker which went into liquidation on 14th March 1989;

Bowers Cadle & Co.Ltd. (AFBD) a futures and options dealer for private clients which went into liquidation on 15th March 1989.

Fox Merton & Co.Ltd. (TSA) principal dealer in securities for private clients which went into liquidation on 15th March 1989.

Greenman Investment Management Ltd. (FIMBRA) a financial and investment adviser which went into liquidation on 12th April 1989.

Dilemmas facing the small investor

7.35 The dilemma facing the small investor is neatly illustrated by the affairs of Nicholas Young, who was apparently a former executive director of a firm of chartered accountants and who was in July 1990 charged with offences relating to deception and forgery. According to an article by John Edwards in *The Independent on Sunday,* 2nd September 1990, investors erroneously believed that his business was connected with the accountancy firm whereas he had been acting in a private capacity. That being so and since he was not authorised to handle investments, a spokeswoman for the SIB is reported as saying that there was no possibility of any losses sustained by investors being covered by the Scheme.

7.36 We note with concern the problems now faced by FIMBRA, whose difficulties with current compensation rules are hardly calculated to instil confidence into the investing public. Unless the SIB, and ultimately the government, is bound to bail out an SRO, investors cannot be guaranteed even the maximum levels of compensation in the case of a run on the fund. (The amount lost in Barlow Clowes, £150 million, would have bankrupted the present compensation fund of £100 million).

Our views

7.37 By and large we believe that there exists a general and genuine desire to give effect to one of our identified minimum objectives (para. 2.29) to the effect that there should be a requirement for access to sound, reliable, expert advice and an effective and speedy compensation system if things go wrong together with the requirement for swift and effective remedies against defaulters. Apart from the narrow problem regarding compensation stemming from confusion of who is or is not authorised, our concern is that the principle of compensation should not be impaired and that the existing uncertainties and ambiguities regarding its application should be removed. The rationalisation envisaged by the Clucas Report with its emphasis on the private investor as a consumer in a retail market will provide the ideal opportunity for clarifying the principle and its application.

7.38 We think that the small investor is entitled to know precisely with whom his or her funds will be deposited, although we recognise that it is difficult, if not impossible, to cater for the prevention of every ingenuity of fraud or deception.

7.39 We have not been able at a more detailed level to deal with administrative matters such as how quickly compensation is paid. Our concern at the general level is to emphasise how retrograde any proposals to abolish the compensation arrangements would be and to recommend that they could usefully be backed by an independent Ombudsman system.

7.40 We are also concerned about the unwieldy size and divergence of the regulatory structure as a whole and consider that another of our identified requirements (in para. 2.29) for a clear, comprehensive, straightforward and easily understandable regulatory structure is not being met.

7.41 We also think that there is much to be said for a uniform compensation system throughout the European Community, a theme to which we return in Chapter 11.

Chapter 8

THE PROCESS OF REAPPRAISAL BEGINS

The growing concern

8.1 By the first anniversary in April 1989 of the coming into force of the Financial Services Act 1986 there was a growing feeling that the baby that was to have brought joy to investors as their protection from rogues had left such a trail of chaos in its wake that they must seriously have been wondering whether it was worth all the trouble.

8.2 Reviewing the first year of investor protection in *The Times,* on 29th April 1989, Vivien Goldsmith reached the conclusion that the customer was paying for 'an Act of confusion'. It was generally recognised, even by the SIB, that the Act needed to be taken in hand. Indeed the Chairman of the SIB was reported to have vowed to re-write the mass of rules and regulations under the Act in plain English and to simplify the details in order to return to the principles that were supposed to be upheld by them.

8.3 The first Report of the unit trusts Ombudsman, published in March 1990 (see *The Financial Times,* 4th March 1990), drew attention to three areas of misunderstanding amongst investors purchasing Unit Trusts, although his findings are or wider and more general application:

(i) it was found that investors had a very different perception of the meaning of 'risk' compared to the fund managers and intermediaries using that term:

(a) the investor is likely to consider 'risk' as meaning fraudulent misappropriation of funds by fund managers;

(b) others, having had the concept explained to them, felt that even if their income were to vary, their original capital would always remain intact;

(ii) the small investor, accustomed to deposit-based savings, frequently has difficulty understanding how unit trusts operate, in that the latter tend to produce a stable income while their capital values can vary considerably;

(iii) investors failed to understand that equity-based investments were not suitable for a short-term investment if the investor might wish to withdraw cash in the near future.

8.4 It is also a matter for growing concern (see, for example, the article by Eleanor Howard, 'Siren call of the policy pushers' in *The Sunday Correspondent* on 10th June 1990), that the language used in products and their promotional literature in the financial services market is sometimes emotive and

misleading, playing on the insecurities of the reader by the use of phrases such as 'Benefits that never decrease', or 'Low cost premiums that never increase', or 'Are your loved ones adequately provided for or perhaps you would like to leave a nest-egg for your grandchildren?'. There is frequently no explanation, for example, of the effects of inflation on the 'real' value of the benefits or the fact that the quoted premiums appear low simply because the ultimate benefits are low.

8.5 The investor is all too often being lured by the device of 'free gifts', but he is just as likely to experience difficulty in appreciating the product's real merits or demerits amongst a welter of cheery assurances such as 'You can cash in your plan early' and slogans such as 'How much richer would you like to be in ten years' time', accompanied by the inevitable picture of a cheque for a large amount.

8.6 The liquidation of Dunsdale Securities Ltd., on 7th June 1990, with an estimated £7m. or more owed to over 200 clients (see para. 4.27) set off a further debate in the press regarding the adequacy of the amounts available under compensation schemes. It was observed by Lorna Bourke in an article 'Investors see a sense of security in troubled times', in *The Independent* on 16th June 1990, that while a maximum sum of £48,000 by way of compensation would obviously be better than nothing, it would be a mere drop in the ocean for those investors who had invested £100,000 or more. Such a sum is not necessarily a massive amount these days in the context of average house prices.

Ministerial observations

8.7 In a speech delivered at a conference on International Cooperation and Reciprocity in Financial Regulations, reported in *The Times* on 4th July 1990, John Redwood, a Junior Minister at the Department of Trade and Industry, expressed sympathy for the plight of the small investor:

> 'Investors will naturally be upset if they discover all their money has disappeared into the pockets of their fund manager . . . . . or if their investment professional was busy dealing in risky securities when they thought their cash was safe.'

8.8 The Minister recognised that investors expected the regulators to protect them from 'fraud, theft and daylight robbery'. He also acknowledged that the public need to be reassured about the level of policing in the City and that while no regulator could offer a 100% guarantee against fraud, it was his responsibility to try and make it as difficult as possible for such things to happen. Writing and re-writing rule books was, in the Minister's view, not likely to increase the chances of catching a crook: 'If he lies about the basics he can fabricate rule compliance'.

8.9 The observations of the Minister regarding the responsibilities of the regulators echo what the Ombudsman had to say about the failings of the Department of Trade and Industry in its regulatory role as regards Barlow Clowes (see paragraph 8.13 of the Report):

> 'It is right that I should say something about what might be represented as the harshness of a conclusion that compensation should be paid on account of, it might be said, some minor oversights. For my part, however, I would not look at the matter in that way. A regulatory agency - which is what the Department were at the time in relation to the protection of investors - ought, to my mind, by definition to adopt a rigorous and enquiring approach as regards material coming into its possession concerning an undertaking about which suspicions have been aroused . . . . . And it was, in my view, the lack of a sufficiently rigorous and enquiring approach which led not only to the failure to appreciate that there was a Jersey partnership but also to some others of the faults I have identified.'

Further disquiet

8.10 In a commentary in *The Times* on 22nd February 1991 Marie Jennings pointed out that consumers are paying about £50m. a year for the cost of regulation. In at least three recent cases relating to tied agents and appointed representatives of well-known financial organisations as much as £12m. belonging to about 675 investors was missing, paid into schemes not covered by the regulations and therefore potentially lost.

8.11 The article noted with concern: 'Practices with regard to complaints procedures, cross- selling techniques, marketing hype and product claims still leave much to be desired ... some of the worst practices are in some of the largest and most prestigious companies'. Only one of the 14 members of the SIB Board is a consumer representative. Plainly such an imbalance ought to be corrected in the consumer's favour, if consumer pressure to eliminate such practices is to be directed effectively. We believe that greater consumer representation could inevitably affect the SIB's attitude to other policies, such as its proposal to expand the scope for 'cold-calling', its refusal to increase the current compensation levels, the proposed relaxation of the polarisation rule for SFO members and broker fund managers, and its reluctance to require disclosure of commission paid to tied agents.

8.12 So far as specific instances of wrong-doing are concerned, we do not have access to the most up-to-date information, although as of April 1990 the SIB investigated 330 complaints of allegedly unauthorised persons carrying on investment businesses, intervened to restrict activities of investment firms or prevent them from disposing of their assets on 13 occasions, and forced the winding-up of 11 firms. The TSA had licensed its 1,000th firm, issued 146 warnings over rule breaches, taken action on 20 more serious enforcement matters, carried our 15 full disciplinary cases, and suspended seven firms and 13 individuals. IMRO had received complaints from investors against 208 of its 1,179 members. 53 have been sent to the Investment Referee. Of 89 members disciplined, 85 were guilty of submitting late returns. LAUTRO had 664 members, 3,000 complaints, and was seeking to double its original enforcement

team to 30 people by the Summer of 1990. More recently, FIMBRA has some 7,000 members and 23,500 registered individuals. Since April 1988 it has suspended 416 firms, with some 135 disciplinary cases outstanding. A modest number of referrals have been made to the Investment Referee.

The Clucas Report

8.13 The submission in February 1992 of this report on a study by Sir Kenneth Clucas on a new SRO for the Retail Sector is an extremely welcome development. Its importance in the field of protection for the small investor cannot be under-estimated and we have accordingly added at a later date a further Chapter to our report to take account of some of its proposals: see Chapter 6.

8.14 We very much wonder whether the interests of the small investor might not be better served by the existence of a central enforcement agency, thus avoiding the duplication of regulatory activities involved with many different SROs.

Chapter 9.

ADVERTISEMENTS

The Risks

9.1 The critical moment for the small investor is when he decides to put his signature to the transaction and to part with his money to an intermediary for investment. If his confidence in the intermediary should turn out to have been misplaced he runs the grave risk of losing the whole or substantially the whole of his investment.

9.2 It is therefore vital that the small investor has ample opportunity to come to an informed and balanced decision about the nature of the investment he is contemplating and the risks he will be undertaking. Nothing should be placed before him which is calculated to vitiate or undermine the decision-making process. If, as often happens, he has the advice of a professional adviser of integrity and repute (who not infrequently may also act as intermediary) all will almost certainly be well, although there can never be any absolute guarantee of safety.

9.3 The presence of such an adviser is by no means always the case. It was a feature of the Barlow Clowes affair and most of the other examples given in Chapter 4 that the products were heavily advertised in the press, to which many of the investors whose savings were subsequently misappropriated responded directly without the advantage of any independent professional advice. It is therefore of the utmost importance that the promotional material and advertisement copy used to solicit the funds of small investors are entirely free from misleading, deceptive or false information. This, again, we identified as one of our minimum requirements for the protection of the small investor (para. 2.29 above: the need for honest, accurate, informative and reliable advertising and promotional literature).

9.4 In this respect an admirable description of the responsibilities falling on those engaged in the advertising industry generally is to be found in the *British Code of Advertising Practice* (8th Edition, published in December 1988) which was prepared in consultation with a wide range of advertising trade associations. The code provides that all advertisements to which it applies should be prepared with care and:

> '..... with the conscious aim of ensuring that members of the public fully grasp the nature of any commitment into which they may enter as a result of responding to an advertisement. Advertisers should take into account

that the complexities of finance may well be beyond many of those to whom the opportunity they offer will appeal and that therefore they bear a direct responsibility to ensure that in no sense do their advertisements take advantage of inexperience or credulity.'

9.5 We are particularly concerned that far too often these standards of behaviour are not being complied with. It is, we believe, a matter of great public concern that prospective investors are being bombarded with financial advertising, both in the press and by the increasingly popular medium of direct mail, which continues to be misleading, notwithstanding the new tier of regulation provided by the Financial Services Act 1986 and the more detailed rules of the SIB and the SROs.

9.6 In the course of our admittedly limited survey of the format of financial advertising we have been struck by the frequency with which even large and respectable financial institutions appear to have been pedalling products which, when subjected to close analysis, were found to be of little intrinsic worth and scarcely worthy of the description 'investment', but which were dressed up in such colourful and emotive language as to beguile the inexperienced, unwary, or simply greedy individual into purchasing them. The critical comment in the press mentioned in Chapter 8 suggests that our views are shared by others who are better placed than ourselves to judge what is happening.

The EC background

9.7 The legal framework for the control of misleading advertising is certainly impressive. The European Community Council has adopted a directive relating to the approximation of the laws of member states concerning misleading advertising, following a proposal of the E.C. Commission submitted in 1978: E.C. Council Directive 84/450. Article 2 of the Directive defines 'advertising' as:

'the making of a representation in any form in order to promote the supply of goods or services in their place'

The expression 'misleading advertising' is defined as meaning:

> 'any advertising which in any way, including its presentation, deceives or is likely to deceive the persons to whom it is addressed or whom it reaches and which, by reason of its deceptive nature, is likely to affect their economic behaviour ...'

9.8 Under Article 4 member states are obliged to ensure that adequate and effective means exist for the control of misleading advertising in the interests of consumers as well as competitors and the general public. Following a consultation document issued in July 1985 by the DTI concerning implementation of this directive, the Control of Misleading Advertisements Regulations came into force on 20th June 1988. However by Regulation 3(1) investment advertisements are expressly excluded from these regulations. It is therefore necessary to turn to the Financial Services Act to see how this implements the Directive.

The FSA

9.9 Section 47 of the Act of 1986 prohibits misleading statements and practices:

> '(1) Any person who
> **(a)** makes a statement, promise or forecast which he knows to be misleading, false or deceptive or dishonestly conceals any material facts; or
> **(b)** recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive, is guilty of an offence if he makes a statement, promise or forecast or conceals the facts for the purpose of inducing, or is reckless as to whether it may induce, another person .... to enter or offer to enter into an investment agreement.
>
> **(2)** Any person who does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any investments is guilty of an offence if he does so for the purpose of creating that impression and thereby inducing another person to acquire, dispose of, subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by those investments.'

9.10 The section broadens the protection previously given by the Prevention of Fraud (Investments) Act 1958. But the investor's main line of protection against misleading advertising is to be found in section 57(1) of the Act of 1986 which provides:

> 'Subject to section 58 below, no person other than an authorised person shall issue or cause to be issued an investment advertisement to the United Kingdom unless its contents have been approved by an authorised person.'

9.11 By Section 207(2) of the Act of 1986 the term 'advertisement' is given a wide definition which includes:

> 'every form of advertising, whether in a publication, by the display of notices, signs, labels or show cards, by means of circulars, catalogues, price lists or other documents, by an exhibition of pictures or photographic or cinematographic films, by way of sound broadcasting or television, by the distribution of recordings, or in any other manner .....'

9.12 By Section 57(2), 'investment advertisement' is further defined as:

> '.... any advertisement inviting persons to enter or offer to enter into an investment agreement or to exercise any rights conferred by an investment to acquire, dispose of, underwrite or convert an investment or containing information calculated to lead directly or indirectly to persons doing so.'

9.13 Under section 207(3) an advertisement or other information issued outside the U.K. is treated as issued in the U.K.:

> 'If it is directed to persons in the United Kingdom or is made available to them otherwise in a newspaper, journal, magazine or other periodical publication published and circulating principally outside the United Kingdom or in a sound or television broadcast transmitted principally for reception outside the United Kingdom'.

9.14 Authorised persons under the Act of 1986 are bound by the rules of their SRO, and the conduct of business rules of those SROs provide the second (albeit complex) tier of protection for the investor.

Some sanctions and defences

9.15 The sanctions for an unauthorised person who engages in investment advertising, without the advertisement being approved by an authorised person, are both criminal and civil:

(i) such conduct will constitute an offence carrying a maximum term of imprisonment of two years under Section 57(3);

(ii) such a person cannot enforce an investment agreement reached as a result of such unauthorised advertising by virtue of Sections 57(5) - (7) and any investor who has parted with money in response to such advertising is entitled to restitution and compensation.

It should be noted that SIB core Rule 6 now severely restricts the ability of authorised persons to approve advertisements for unauthorised overseas persons.

9.16 Section 57(4) provides a special 'media' defence, where advertising agencies and other media businesses issue advertisements to another's order. They will not be guilty of an offence, if they can prove that they believed upon reasonable grounds that:

(i) the person to whose order the advertisement was issued was an authorised person, or

(ii) that the contents of the advertisements were approved by an authorised person, or

(iii) that the advertisement was within one of the exceptions contained in Section 58.

The Rules

9.17 The shifting of the burden of proof by Section 57(4) ought to impose a measure of obligation on the press and other media to check the bona fides of those submitting advertisements to them for publication. Certainly the experience of the members of the Committee has been that prospective investors are indeed very much influenced by the medium in which such advertisements appear; in particular, the 'quality' press lends an aura of respectability to what may be otherwise an entirely misleading piece of advertising. It is thought that the publisher of an investment advertisement is not liable to a civil action for damages by a disappointed investor.

9.18 Turning to the Rules one is faced with a phalanx of provisions made both by the SIB and the various SROs. Despite the extremely detailed nature of these provisions regulating the form and content of advertising, the Committee believes that all that has happened in practice is that even the most respectable financial institutions with products to sell are complying at best with the letter of the Rules, and sometimes not even that far.

9.19 If, as we believe, there exists considerable cynicism in this respect within the financial services industry generally it must be deplored. It suggests to us that there must be a redoubling of efforts on the part of the SIB and each SRO to ensure the systematic monitoring of investment advertising and the hounding of misleading advertisers. A degree of missionary zeal is called for if there is not to be a permanent decline in standards in this respect.

9.20 We have also gained the impression, justified or not, that there are varying degrees of enthusiasm amongst the SROs themselves for this task and it will therefore be up to the SIB to try and ensure uniformity of approach and standards within the investment industry as a whole.

9.21 Rule 7.07(1) of the SIB's Conduct of Business Rules provides that:

> 'The content of an advertisement and the manner of its presentation shall be such that the advertisement is not likely to be misunderstood by those to whom it is addressed including, if it be the case, persons who cannot be expected to have any special understanding of the matter in the advertisement. Rule 5(1) of its new Core Conduct of Business Rules requires a firm issuing or approving an investment advertisement to apply apapropriate expertise, and to show that it reasonably believes the advertisement to be 'fair and not misleading'.

9.22 The remainder of the Rule provides that advertisements must not contain any statements, promises or forecasts or statements purporting to be a statement of fact, or express any opinions on behalf of any person, unless the firm reasonably believes the same to be true. Similar provisions are to be found in the Rules of the SROs; interestingly, FIMBRA expressly provides in its Rule 18.1.1 that members are obliged to observe advertising standards administered by the Advertising Standards Authority and the Independent Broadcasting Authority and their relevant codes of practice. It is not possible for us to give an exhaustive analysis and comparison of the various rule books.

9.23 The SIB does itself, however, impose certain requirements regarding advertisements to the following effect:

(i) they are not to imply Government or SIB approval of the investment concerned;

(ii) any synopses of the rights and obligations attaching to an investment, or its terms and conditions must be fair;

(iii) proper Risk Warnings must be given;

(iv) references to taxation must carry a taxation warning and state that the value of any tax relief will depend on the individual investors' circumstances, and furthermore must make plain the tax considerations upon which the advertisement relies;

The requirements also deal with the use of testimonials, the use of limited issues or deadlines, the use of data concerning past performance of investments, and certain specific information relating to 'off-the-page' advertisements of life policies and regulated collective investment schemes.

Is this regime effective?

9.24 A primary aim of this mass of regulatory material must be to ensure, in the words of the British Code of Advertising Practice, that in no sense do advertisements take advantage of inexperience or credulity on the part of the small investor. There is disquieting evidence in the form of the growing volume of press criticism mentioned in Chapter 8 and our own observations that this basic objective is far from being generally met.

9.25 If this is indeed so and those engaged in the preparation of advertising material and the exploitation of other advertising techniques are insufficiently conscious of their responsibilities to the small investor, then it is imperative that any such tendency is quickly corrected. A failure now to grasp the problem could have serious implications for the future.

9.26 Already the small investor faces a deluge of investment advertising, not just in newspapers and on television, but through inserts in magazines, domestic bills and the ever-increasing use of direct or 'junk' mail. A favourite technique is to target a particular group of consumers, selected with the help of developments in information technology and aids such as free telephone calls, not to speak of 'free' gifts.

9.27 It can surely only be a matter of time before developments in such spheres as satellite broadcasting and the growing use of home computers will mean that households are likely to be the target of advertisements through methods as yet almost unknown. As matters stand at present financial institutions such as banks and insurance companies are already engaged in building up data systems which are exploited for the cross-selling of products to consumers, most of whom are entirely ignorant that they are the victims of such tactics. The investing public needs to be made fully aware of the existence of such practices and their implications.

9.28 Advertising by means of the written word is, however, but a part of the problem. The more gullible investor will be ready prey to the door-to-door or telephone salesman as some of investment scams mentioned in Chapter 4 of this Report have indicated. The Committee has never been convinced by the age-old assertion by the insurance industry, to the effect that life assurance is never purchased, only sold, nor do we understand why it is necessary to extend the marketing relaxations, permitting cold calling of Unit Trust products as well.

9.29 Further, the Committee viewed with some concern the SIB proposals aimed at achieving a common regulatory regime for cold-calling (see SIB Consultative Paper 44, October 1990, entitled *The Proposed Common Regulations on Unsolicited Calls*) which in effect proposed to liberalise the marketing of other retail investment products (such as shares in investment trust companies held through saving schemes) by levelling the playing field down in this context. Of even greater concern, if the SIB's proposals were implemented, would be the ability of stockbrokers, FIMBRA members and the like to cold-call discretionary investment services relating to certain listed securities. The Committee would prefer instead to see a ban introduced on door-to-door (and unsolicited telephone) selling of all investments and investment products.

Continued Vulnerability

9.30 The heart of the problem is that there is an increasing discrepancy between the variety and complexity of products offered in the financial investment industry and the continuing lack of sophistication on the part of the market to which they are directed. Our firm view is that the small investor, whether in the field of insurance policies, pensions and unit trusts or otherwise, remains vulnerable despite the detailed provisions made in the rule books of the SIB and the SROs simply because he or she lacks the necessary 'know how' to understand investment advertising or the risks facing him or her particularly when so much of it remains misleading.

9.31 A recent article by Norma Cohen (*Financial Times* 21 May 1992) reported LAUTRO fining Norwich Union £50,000 (with £15,000 costs), after one of its tied agents placed a misleading advertisement in the *Sun* newspaper for a 15-year savings plan. Headed 'Sun Care 4 Page Special Guide To Our Revolutionary Savings Offer Invest £20 a month and get £120 bonus free!', it appeared to be backed by the paper (which it was not), and brought in some 4,500 customers. Its suggestions that premium payments were constant and levels of return conservatively estimated were misleading.

9.32 This kind of 'hard sell' is not confined to the written word, however: the Consumers' Association reported in a recent survey that agents for 40 mortgage lenders gave inaccurate information to prospective customers, such as that endowment policies were 'guaranteed' to repay a mortgage on maturity (which is untrue). While the Consumers' Association is reported as blaming the system of commissions, the fact is that widespread public ignorance enables this sort of mendacity to flourish.

9.33 The consumer credit industry had already been the subject of repeated attack for its eagerness to extend loans to people who are wholly unfit to receive them either because of the extent of their existing indebtedness or because of their modest financial circumstances or expectations. It accordingly became necessary to introduce regulations recently designed to ensure that all advertisements for mortgage lending contain an express warning that

borrowers may be at risk of losing their homes in the event of default. The previous risk warning to the effect that 'interest rates can go down as well as up' was considered to be inadequate.

9.34 The present risk warnings in investment advertising are, we believe, similarly inadequate. It is hoped that our report will help to generate a wider awareness of this problem in particular and, more generally, the problems posed for the small investor by the use of misleading or unacceptable advertising material and practices.

Conclusions

9.35 We thus consider that our identified requirement for honest, accurate, informative and reliable advertising and promotional literature (para. 2.29 above) is not being met. We, accordingly, have in particular, the following recommendations to make:

(i) There should be requirements for advertisers in the financial investment sector to explain their products in clear and simple English, giving prominence to the limitations of any claims made for the product.

(ii) **(a)** Such Risk Warnings as exist at the moment should be changed to highlight the possibility that a prospective investor might lose his or her money altogether;

(b) 'Investment can Seriously Damage your Wealth' is a slogan which has occurred to us; in any event the comparison with the new risk warning for home-owners under the current mortgage-lending regulations could provide a useful precedent;

(c) Prominence should also be given to the limits of the compensation scheme available.

(iii) Gimmicks and inducements such as 'free' gifts ought to be outlawed; in the context of financial advertising they are calculated to put unfair pressure on the prospective investor and to distort the priorities which should be taken into account when making investment decisions.

(iv) The SIB and the SRO should publish their respective track records in monitoring misleading and illegal advertising and should be seen to deploy the full range of sanctions at their disposal against the makers and issuers of such advertising; a degree of missionary zeal is imperative if the abuses which we believe now occur with some regularity are to be terminated.

(v) As well as a greater degree of regulation for advertisers, much needs to be done by the SIB and the SROs to educate the investing public about their rights and what can legitimately be expected by way of protection under the present regime; two excellent little pamphlets entitled *Self Defence for Investors* and *How to Spot the Investment Cowboys* have already been published by the SIB and, having regard to the lack of sophistication among small investors, a useful sequel might be produced on *How to Read Investment Advertising* to correct the bias against understanding which is apparent in the format and content of so much investment advertising.

9.36 We also support the proposal of the Bow Group (see *Financial Times*, 12th November 1990) that personal finance should in future form part of the core school curriculum in the United Kingdom.

Chapter 10

TRUST PROBLEMS

Training

10.1 In this chapter we examine another of our minimum requirements, namely that there should be swift and effective remedies against defaulters (para. 2.29) in the context of the insolvent company. This can affect the small investor in a number of ways, some more obvious than others. For example, if the company in which he or she has invested and has become a shareholder or contributory goes into insolvent liquidation, the small investor (indeed any investor) in such a company is probably unlikely to recover anything, certainly not before creditors are paid.

10.2 But this is not the only situation that can arise. Suppose, for example, it is the intermediary or broker who has gone into liquidation (or bankruptcy). What then? Normally there ought to be no problem if the investor's shares are already registered in his or her name. But what if they are not? What if they are registered instead in the name of a nominee company pending more formal registration? What if the contract to purchase the shares has been made, but not completed and meanwhile the cheque for the purchase price cashed? What if there is a running account between the broker/intermediary and the investor or potential investor? What if the broker or intermediary is managing a discretionary fund?

10.3 In these types of situation the extent to which the small (or, again, any) investor may recover may depend entirely on the ability to trace his or her money or shares into the hands of the person holding any such money or shares. This, in turn, may depend on the accuracy of the records maintained and whether or not client accounts or separate trust accounts are maintained. Even where trust or separate accounts are maintained the insolvent intermediary or company may have mixed them with his own.

10.4 Where the investor claimant can identify his or her own moneys or shares, if necessary by recourse to the equitable rules of tracing, there ought to be no problem, for the liquidator or trustee in bankruptcy may only have recourse to the free assets of the insolvent, that is those not beneficially vested in another. Even where there has been some mixing or misappropriation, if the investor can trace his moneys or shares (or the proceeds of the shares) into an identifiable fund or pool, he or she might still be able to a charge over the fund or pool to the extent of his interest.

10.5 For the small investor, however, proceedings to establish his or her claim, particularly if the records of the insolvent are poor or muddled, can, as appears from the cases cited in Chapter 4, be extremely costly and time consuming.

10.6 Moreover, particularly if the insolvent is an intermediary, as experience on recent public share offers showed, it may be that the liquidator has immediately on taking office a different task of establishing precisely what assets are owned by the insolvent beneficially (i.e. what are free assets) and what assets are owned beneficially by third parties.

10.7 If the funds which the small investor (usually in conjunction with many others) seeks to trace form or may form substantially the whole or a substantial part of the assets coming under the control (or apparent control) of the liquidator or trustee in bankruptcy, this can lead almost to a paralysis of the liquidation or bankruptcy process. The liquidator in such circumstances is or can be severely restricted in what he can do or is willing to do if he may be faced with a real risk that the assets which appear at first sight to be free assets of the insolvent may ultimately turn out not to be available for distribution amongst the creditors of the insolvent but are destined instead to, or to a number of, small investors.

10.8 For the liquidator the problem will be aggravated to the extent that if all the assets apparently under his control do indeed turn out to be beneficially owned by third parties he will be without recourse to funds to finance the cost of investigating the claims and muddle presented to him or pursuing claims against wrong-doers, e.g. defaulting directors.

10.9 Recent cases have shown that the court may be prepared to permit the liquidator to raise and retain the costs of his investigations to determine the true beneficial ownership; of the assets under his control, including his remuneration, out of these assets. Sometimes the order is made without prejudice to the ultimate incident of such costs, i.e. whether the company or the claimants or partly both, and if so, in what proportion, the costs should be borne.

10.10 Whilst this is obviously of some benefit to the small investor, in the sense that it may mean the investigation is made, he or she may and invariably will still suffer some loss, if only by the proportion of the cost he or she has to bear. If the pool of assets is actually smaller than the aggregate of claims then, of course, the loss may be all the larger since the 'cake' then has to be divided and returned in smaller proportions amongst the claimants.

10.11 Even where the liquidator is covered for his costs in the way mentioned above, it is not infrequently met in practice that the liquidator becomes aware of a number of potential claimants from whom he can get no response no matter how many letters he writes. This can effectively delay the administration since the liquidator will then invariably have to seek the sanction of court order in order to make the necessary distribution amongst the beneficial owners. This process can itself lead to additional cost and expense.

Machinery for Binding Dissentients

10.12 There ought, we think, to be some simple and more economic machinery for binding dissentient or absent investor claimants without the necessity of having to obtain in every case a court order particularly, say, where the majority of claimants are willing to agree some compromise. A useful example or analogy is the procedure for binding creditors to voluntary arrangements in Parts I and VIII of the Insolvency Act 1986.

10.13 This, however, would only provide, at best, a modest saving of expense. If the cause of the muddle is inadequate records or failure to hold or maintain proper trust accounts, further compensation might be provided in two ways.

10.14 Firstly, there should be an adequate compensation scheme as discussed elsewhere in this report.

Personal liability of Directors

10.15 Secondly, defaulting directors should be made personally liable for any shortfall of investors funds unless they show good reason why they ought not. Of course the directors are not personally liable as trustees for the assets under the control of their company, but there might be some statutory machinery for making them, in effect, so liable in the event of insolvency particularly if, as we say, the loss is due to maladministration. In the Appendix we have provided a draft Bill which we hope may stimulate discussion and debate as to whether (and if so in what form) personal liability ought to be visited on directors and other officers of the defaulting company in the sort of circumstances envisaged in this chapter. We recognise that this recommendation is by no means perfect. The director concerned may himself be insolvent or have inadequate assets. The real answer, we suspect, is the provision of an adequate and effective compensation system.

Chapter 11

THE PURSUIT OF A LEVEL PLAYING FIELD.

Cross-border problems

11.1 The system of regulation and protection established under the Financial Services Act 1986 is essentially domestic in its nature and extent. It can however be circumvented or overreached by a determined fraudster operating beyond our jurisdictional boundaries.

11.2 The case of SIB v Pantell S.A. [1990] Ch.426, decided on 8th March 1989, illustrates the ease with which abuse of the system from overseas can take place and the dangers to which the unsophisticated small investor at home is potentially exposed: see also SIB v Pantell S.A. (No.2) [1991] 3 WLR 857.

11.3 Pantell had for some months prior to the hearing before Sir Nicolas Browne-Wilkinson VC been sending advertisements of its services from overseas addresses to individuals in this country and offering them investment advice; the impartiality, in particular, of the advice was stressed. The advertisements recommended shares in a United States company, Euramco, describing them as 'the share of 1988'. The shares were said to be publicly owned and traded. The evidence before the court indicated that a Dr Axel H. Schubert was one of the two directors of Pantell.

11.4 Enquiries made by the SIB of the Securities and Exchange Commission in the United States disclosed that Euramco shares were not listed or traded on any Stock Exchange. The evidence further suggested that it would be illegal for a United States dealer to trade in Euramco shares which had been issued in Europe. Further, it had been discovered that Dr Schubert, far from being independent and impartial, was apparently the President of Euramco.

11.5 The SIB had for some time been in contact with the Swiss Authorities and were informed shortly before the hearing by the Public Prosecutor in Lugano that he had taken action to close down Pantell's business because of violations of Swiss banking law and of the law relating to fiduciary firms. The Public Prosecutor had searched Pantell's premises and discovered that Pantell had done business with, and received money from, investors from many countries but mostly from the United Kingdom.

11.6 A press release was issued by the Public Prosecutor in Lugano which has an all too familiar and disturbing ring about it. Criminal proceedings had been initiated against the managers of Pantell for repeated and continuing instances of professional swindling, breaches of the Federal Banking and

Saving laws and violations of Canton law on the obligations of fiduciaries. Pantell and other company associates operating on an international level were said to have led many investors in Great Britain and other parts of the world to be buy shares in private companies at a price vastly in excess of their value. In particular, customers were persuaded to buy shares in Euramco Washington which was supposed to be involved in mining business in Panama.

11.7 The SIB applied for and obtained an injunction to restrain Pantell from any further illegal investment business or advertising and a Mareva injunction restraining Pantell from dissipating its assets. The court was persuaded that where there was a strongly arguable case that a company had been carrying on an investment business without authority in contravention of Section 3 of the Act of 1986 the court had jurisdiction to grant such Mareva relief.

11.8 The SIB continue to be vigilant in monitoring off-shore operators. In May 1990, for example, steps were taken to halt the activities of Vandersteen Associates, a Belgian-based investment company which was making unsolicited telephone calls to English and Welsh investors and issuing unauthorised investment advertisements. This was the first time an injunction had been obtained against individuals operating from outside the United Kingdom: *The Financial Times*, 15th May 1990.

11.9 The threat to the small investor posed by the activities of the likes of Dr Schubert and the Vandersteens cannot be under-estimated. The significance of the problem is world-wide in extent and it is recognised to be so important in the context of the European Community that it is being addressed with some degree of urgency, though the suggested solutions are, to say the least, somewhat complex. To the extent that it is impossible to achieve a level playing field across all Community Members the chief victim will be the small investor.

European Developments

11.10 The European Commission's proposed Investment Services Directive is intended to apply in respect of investment firms carrying on 'investment business' within the Community. The essence of the Directive is that it will enable a qualified firm to obtain a single licence or 'passport' in the Member State where it is authorised ('the Home State') which will enable the holder to establish branches or provide services in any of the other Member States ('the Host States'). Home State authorisation will be granted once an applicant has satisfied the authorities that it has met essential minimum requirements as to, for example, its capital resources, 'fitness and properness', together with prudential supervision and control.

11.11 The Second Banking Directive has now been brought into force and may be regarded as having distorted the market for those 'investment business' services which can be provided in the Community by credit institutions, by having given such institutions a similar 'passport' to enable them to undertake securities throughout the Community.

11.12 The terms of the Investment Services Directive are still under consideration by the Commission and it remains uncertain when it will be implemented. This is due, mainly, to the apparent deadlock which has arisen between certain Member States (notably the more restrictive Member States in the South and the more liberal Northern ones such as the UK and Germany) over issues such as transparency and reporting.

11.13 Whilst the Commission has been concerned to prevent mail-box registration, (i.e. the concept of setting up a registered investment business in a Member State with a reputedly lower regulatory standard for the sole purpose of using the single licence thus obtained to set up branches and provide services in other Member States), it should also be realised that too strict a Home State regime may encourage firms to relocate their headquarters in financial centres in the community which apply less stringent standards. As the United Kingdom may be regarded as the most highly regulated market for investment services in the community at the present time, it has reason to be concerned.

11.14 As the SIB has pointed out in its Consultative Paper No.28 referred to in Chapter 7, the position under the current proposals is that responsibility for compensation schemes in the European Community will be divided between the Home and Host States. Thus although a company established in another Member State but operating through a branch in the U.K. would need to belong to the U.K. Compensation Scheme, an investor doing business with a company established in another Member State and operating in this country merely on a services basis, will only have recourse to any scheme in that company's Home State. This could result in some U.K. investors of Community companies not being adequately protected by the availability of compensation in the event of default of the investment firm.

11.15 The problem of the 'unlevel playing field' in this respect is exacerbated by the extent to which the provision of compensation is or is not equivalent or uniform in the Member States and this in turn raises a further problem, namely, the extent to which any such lack of protection in any relevant Member State will require to be drawn to the attention of investors in the U.K. by appropriate risk warnings connected with any particular product.

11.16 The position in the U.K. whereby investors are faced with marketing literature in respect of such products from Community Member States and which merely contain risk warnings that they are not protected under the U.K. Investors Compensation Scheme and with the suggestion that they may wish to take professional advice, is not considered satisfactory.

11.17 The Commission appears to accept that firms should be required to inform investors which compensation scheme will apply to them, or alternatively, to tell them if there is no such applicable scheme. In addition, pending harmonisation of compensation schemes, the host country will be able to require that its compensation scheme will apply where the home

country's scheme is inadequate. However the question of whether the home or the host country's scheme will prevail is now likely to be dealt with by the Commission in a further Directive in due course.

11.18 Finally, we consider that the Directive should also provide for a specified minimum level of compensation in any claim (for example, up to 90% of a specified, but indexed, minimum sum).

Chapter 12.

CONCLUSIONS

12.1 When the Committee embarked on its task our first reaction was one of bewilderment at the sheer immensity and daunting nature of the new system for investor protection. To the extent that it has been possible in the time and with the limited resources available to come to grips with the system at all, we consider that our initial feelings were more than justified. If only judged from the standpoint of the small investor, we believe that the system is, at the very least, most unsatisfactory and that it promises more than it can deliver. A cynic might observe that in this sense it shares a characteristic in common with some of those whose reprehensible activities it is seeking to eliminate.

12.2 Whatever the administrative deficiencies and cost effectiveness of the new system may be and upon which we are in no position to express a view, it must be a matter of concern that there are so many organisations and bodies involved in the regulatory field. The acronyms of LAUTRO, FIMBRA, IMRO and the rest have the ring of biblical incantations and we wonder what the sight and sound of these names in the media has upon the small investor. If they mean anything , which we doubt, they must surely indicate that the provider of a product in the financial services field measures up to a prescribed set of acceptable standards and has earned the right to be approved and authorised by some kind of official body. The small investor, unless he is extremely pertinacious and sophisticated, will have no comprehension of what such authorisation means or may in the future mean in his particular case. At best he and his advisers, if any, may be lulled into a sense of security that the investment is safe and sound. The recent proposal to set up Personal Investment Authority (PIA) (paras. 6.3 and 8.13) must accordingly be welcomed as a major step towards the improvement of the system.

12.3 On each occasion that a disaster is reported involving the loss or likely loss of the savings of small investors the tendency will be for the system itself to fall more and more into disrepute, having lost the confidence of the very persons whose interests it was supposed to serve. We have some doubts as to whether the new system is or will be effective in eliminating those reprehensible activities (see Chapter 4).

12.4 As frequently noted in the report, there is already in existence a multitude of consultative papers and discussion documents replete with suggestions and recommendations for improvement. At the time of writing our concluding chapter yet further material of this nature continues to emerge from a variety of

official sources. We are concerned that so much tinkering in a piece-meal manner may obscure the need for a more general assessment of the present system and an assessment of whether it adequately serves the needs of the small investor.

12.5 We believe that the time is now ripe for a more objective and independent assessment of the system and that it is short-sighted to stagger from one modification of one part of the system to another without a consideration of the efficacy of the system as a whole.

12.6 The root of the problem lies, we believe, in the very nature of the system itself with the fragmentation of regulatory organisations and the inevitable risk of confusion in the mind of the small investor. A degree of rationalisation is essential if a sensible and fair way ahead is to be devised in place of the present maze of regulatory complexities.

12.7 As is evident from the experience of the small investor from the Langford Scott case to the Barlow Clowes affair, the intervention of the Parliamentary Commissioner for Administration was a watershed in the investors' fight for compensation. The ability to sue any regulatory body under the Financial Services Act 1986 is now, in the absence of fraud, impossible (see section 187 of the Act). Accordingly we believe that since the Parliamentary Ombudsman no longer has a role to play, it is essential to ensure that some effective redress is available to the small investor.

12.8 We thus consider and recommend as follows:

(i) The regulatory infrastructure under the Financial Services Act 1986 is unnecessarily complex, incoherent and not easily comprehensible and should be reconsidered (Chapter 1, paras. 7.9, 7.40 and 12.2);

(ii) We consider that there is an urgent need for a greater weight of consumer representation not only on the Board of the SIB but also on the Boards of the other SROs (para. 6.3);

(iii) The existing compensation scheme should be preserved and its levels increased, it should be government secured and backed by an independent Ombudsman with effective powers (para. 6.16);

(iv) We make recommendations as to advertisements and promotional literature (Chapter 9);

(v) We consider directors and partners in investment businesses should potentially incur personal responsibility (Chapter 10 and Appendix 1);

(vi) We recommend liquidators should have greater powers to compromise claims (Chapter 10);

(vii) We consider that there should be uniformity of approach throughout the European Community particularly in relation to compensation schemes for investors and the minimum level of cover which they provide (Chapter 11).

Postscript

12.9 At a very early stage in our study we were convinced that, at any rate from the standpoint of the small investor, the present system of protection left much to be desired. As we conclude our report in June 1992 there are encouraging signs that some at least of our concerns are also shared by those who have the statutory responsibility for supervising the system.

12.10 In a statement released with the latest Annual Report of the Securities and Investments Board, its outgoing Chairman, Sir David Walker, observed that too many organisations were responsible for enforcing financial legislation and that this had left scope for uncertainty as to responsibilities and inconsistencies of approach. Sir David, as reported in *The Times* on 4th June 1992, has called for a review of the present 'fragmented' regulatory system.

12.11 The call for a review from such an authoritative and distinguished source gives us some satisfaction that our own approach to the subject may not have been entirely misplaced. We urge that a review should be put in hand as speedily as possible, not only on account of the general public importance of the subject but in particular to provide comfort and reassurance to the small investor that his interests as a consumer under the system are being safeguarded in a fair and adequate manner.

APPENDIX I

In Chapter 10 we recommended a short section casting the burden of personal responsibility on directors and others defaulting with investors' funds. This could be on the following lines:

THE FINANCIAL SERVICES (AMENDMENT) BILL
(A Bill to make directors of companies holding trust property and others concerned in the management of funds on behalf of investors personally liable unless good cause is shown as to why they should not be).

1. (i) Where a company is:-

(a) a trustee of property for any other person.

(b) carrying on an investment business and has received property from, or to or for the benefit of, any other person in the course of that business (whether or not such property is held in trust for that other person),

then, in the event that such other person suffers any unrecovered loss in respect of that property entrusted to or received by the company (as the case may be), each and every officer of that company shall be personally liable to that other person as if he were a trustee of such property for the benefit of that other person to the extent of that unrecovered loss.

2. This section and the remedy conferred on any person by sub-section (i) above shall continue to apply notwithstanding the company concerned is being or has been wound up or dissolved.

3. The provisions of section 727 of the Companies Act 1985 (power of the court to grant relief in certain cases) shall apply to any action brought under this section.

4. For the purposes of section 9 of the Limitation Act 1980, the cause of action arising under this section shall accrue on the date on which the company concerned fails to pay or otherwise satisfactorily account for any property due to the person entitled.

5. In any proceedings brought under this section the court shall have power to award and include in any sum for which judgment is given simple interest at such rate as the court thinks fit on all or any part of the sum in respect of which judgment is given, or payment is made before judgment, for all or any part of the period between the date when the cause of action arose and:

(a) in the case of any sum paid before judgment, the date of the payment; and

(b) in the case of the sum for which judgment is given, the date of the judgment.

6. In this section the following expressions have the meanings assigned to them, that is to say;

'company' includes any partnership;

'investment business' has the meaning assigned by section 1(2) of the Financial Services Act 1986;

'officer' in relation to a body corporate means and includes any director, shadow director, manager or secretary, and in relation to a partnership means any partner of that partnership:

'property' includes money, goods, things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property;

'shadow director' has the meaning assigned by section 251 of the Insolvency Act 1986;

'unrecovered loss' means loss howsoever arising to the extent that the value of the property which the company ought otherwise to have paid or delivered to the person concerned is not, or can not be, replaced or recovered by the company (whether by reason of insolvency or otherwise) or any other person or out of any other fund.