Fraud: put up your stop signs

***Deborah Sabalot** explains how the new offence of failure to prevent fraud could intersect with Consumer Duty to make it easier to prosecute accused financial services firms*

Fraud is the most common offence in the UK, amounting to 41% of all crime against individuals in the year ending September 2022. Yet establishing accountability for fraud within companies has proved to be an elusive government policy objective.

A 2022 House of Lords report on fraud pointed out that it is far from a victimless crime and that no one would stand for it "if citizens were being routinely mugged and having millions of pounds stolen from their wallets in broad daylight". The report argued that, because most fraud is now online and is enabled by technology, victims have often been lulled into taking part in or agreeing to the deception through 'social engineering'. In doing so, they facilitate a crime that is mostly invisible and protects fraudsters who are unlikely to get caught. The Lords wants that to change and has amended the Fraud Act 2006 to include a new criminal offence of failing to prevent fraud.

> *The Bill gives authorities new powers to fine and prosecute certain 'relevant bodies', including charities*

In early 2022, the Law Commission published an Options Paper, setting out detailed proposals for the reform of corporate criminal liability in England and Wales and advocating for the creation of a 'failure to prevent' offence for fraud. The Lords Committee and the Law Commission both argued that the available regulatory punishments for internal fraud did not appear to be a sufficient deterrent.

The offence of failure to prevent fraud

This new offence of 'failure to prevent fraud' has been created under the Economic Crime and Corporate Transparency Bill 2023. As *Financial World* went to press, the Bill had passed its third reading in the Lords and been passed back to the Commons for legislative 'ping-pong'. The Lords' amendments had not yet been agreed and Royal Assent had not yet been given.

If agreed, the Bill gives authorities new powers to fine and prosecute certain 'relevant bodies', including big companies and partnerships as well as large, not-for-profit organisations, including charities and incorporated public bodies. The offence also applies to all sectors and not just financial services firms.

A relevant body may be guilty of an offence if an employee commits one of the listed fraud offences with the intention of benefiting, whether directly or indirectly, the employer. But if the company itself was, or was intended to be, a victim of the fraud offence, there is no case to answer.

Also, if the company had in place the sort of procedures to prevent fraud by employees that it would be reasonable to expect, it has a defence. The government will be under a statutory duty to publish guidance on what would be considered reasonable fraud prevention procedures.

The courts may impose a fine on the relevant body which is unlimited, although company bosses will not be held individually liable where it can be established that they had no knowledge of the offence.

The new offence will apply throughout the UK but it potentially has extraterritorial effect as well. If an employee commits a fraud offence under UK law, or targets UK victims, the employer could be prosecuted even if the organisation – and the employee – are located overseas.

The directing mind and will

One key feature of the new offence is that it attempts to cut through the 'identification principle' of corporate governance.

Developed in 1915 by the House of Lords and reaffirmed in 1971 in *Tesco v Nattrass* [1972] AC 153, the identification principle attributes criminal culpability to a company where it can be shown that an individual who is 'the controlling mind and will' of the company is guilty of an economic offence, such as fraud.

The Financial Conduct Authority's (FCA) Senior Managers and Certification Regime (SM&CR) requires firms to identify those carrying out senior manager functions and to have a 'Statement of Responsibility' outlining the areas that those people are responsible and accountable for. However, the large and often opaque governance structures of many companies has made accountability challenging. In a sprawling organisation with cross-cutting functions, it can

be hard to identify a senior manager in charge of specific operations where an offence may have been committed.

That same challenge has made the identification principle largely toothless when applied to the criminal offence of fraud. Prosecutors have found it almost impossible to establish that anyone in a key decision-making role actually made the decision that led to a fraud. This has particularly benefited larger organisations because smaller ones have less complex structures and more direct reporting lines – so less scope for denying that any one person or persons knew what was taking place.

> *Companies will need to review their anti-fraud policies and procedures as part of Consumer Duty*

Of particular note was the High Court's 2020 decision in *Serious Fraud Office (SFO) v Barclays*, which found that neither Barclays' chief executive nor its group finance director could be said to be a 'directing mind and will' of the company.

In that case, the SFO had charged Barclays with two counts of conspiracy to commit fraud contrary to section two of the Fraud Act 2000 and section one of the Criminal Law Act 1977, and one count of financial assistance contrary to section 151 of the Companies Act 1985. It was alleged that the bank had conspired with senior executives to pay 'disguised commission' to certain Qatari investors in the course of two capital raisings and a loan, which together were worth £11.2bn. The funds were raised during the global financial crisis, when banks found it extremely challenging to attract investors. Barclays had also faced a charge of financial assistance.

The Crown Court ruled that the alleged criminal dishonesty of senior officers could not be attributed to Barclays. The High Court, effectively acting as an appeal court, upheld the ruling in refusing the SFO's application to present a voluntary bill of indictment, which is a fresh evaluation of the facts ordered by a judge.

Barclays argued that the 'directing mind and will' of the bank comprised the full board and particular committees rather than one or two individuals. It also argued that, as those entities had not delegated their authority to the defendants either expressly or by necessary implication, those individuals could not be described as the directing mind and will of the bank.

The new offence of failure to prevent fraud will cut through this and allow prosecution of the relevant body and not just the individuals who may or may not have been involved.

Consumer Duty and the 'failure to prevent' rules

This change comes into force at the same time as the FCA's new Consumer Duty rules, which include a requirement that financial services firms build 'appropriate friction' into their processes to reduce the risk of consumer harm and otherwise deliver good outcomes for consumers. That friction is intended to make sure that consumers are able to understand and assess what is going on, including any risk of their falling victim to fraud either by, or with, the connivance of the relevant body.

Companies subject to the new 'failure to prevent fraud' offence should, therefore, make sure that they have reviewed their own internal and external anti-fraud policies and procedures as part of their preparation for implementing the Consumer Duty. They will need to ensure that they can mitigate any risk of a fraud being committed by an associate or employee for the benefit of the organisation and that adequate security, training and due diligence procedures are in place to avoid not only civil but criminal liability.

This intersects with the requirements of Consumer Duty to act in the best interests of the retail customer and will potentially catch companies that engage in dishonest sales practices, false accounting or hiding important information from consumers or investors.

The firm pays the price

The offence of 'failure to prevent fraud' adds a new dimension to the debate on the 'directing mind and will' of a company and to the accountability of the board. Prosecutors will no longer have to demonstrate that those in control of a company carried out a particular fraud for the company to be liable. It will be enough that the firm benefited and had not put in place measures to prevent fraud.

The upshot is that companies falling within the scope of the new Act will have to give careful consideration to their compliance and governance structures. They will also need to decide how to put in place appropriate fraud prevention processes and procedures to combat internal fraud. ■

__Deborah Sabalot__ is a consulting lawyer who advises financial sector clients on UK and international regulatory and compliance issues