

Chapter 1

The FSMA Regime

Simon Gleeson

Partner
Allen & Overy LLP

1.1 The regulatory regime governing investment banking

Financial Services in the UK are governed by the Financial Services and Markets Act 2000 (“FSMA 2000”). This Act establishes the Financial Services Authority (“FSA”) as a single regulator to govern all forms of financial activity, from insurance to securities trading and mortgage intermediation. The scope of the FSMA 2000 is determined partly by EU directives (which require the FSA to regulate at least certain types of activity) and the policy of the FSA (which sometimes regulates activities which are unregulated elsewhere¹ but at other times does not regulate activities which are generally regulated²).

In the past, financial services were regulated by the Prevention of Fraud (Investments) Act 1958, investment banks were merchant banks, and investment banking meant corporate finance. In the 1980s, merchant banks either became or were acquired by investment banks, and the Financial Services Act 1986 (“FSAct 1986”) was enacted to regulate financial services. Under the Prevention of Fraud (Investments) Act 1958 corporate finance was broadly unregulated, and when the FSAct 1986 was in gestation there was considerable debate as to whether corporate finance should be regulated by the Act. The point was left to the Securities and Investment Board (the predecessor of the FSA), which initially made rules that had the effect of exempting corporate finance from regulation. However, this policy was soon reversed and corporate finance is now subject to regulation in much the same way as any other activity. Simultaneously the evolution of investment banks took them into every

¹ There can be few other jurisdictions which treat the sale of funeral plans as financial services.

² For example, the UK is one of the relatively few EU countries in which lending money to non-consumers is almost completely unregulated.

area of financial activity, and the scope of regulation rapidly became almost coextensive with their activities. Investment banks and the FSA today have a symbiotic relationship and the extent of regulation and the limitations placed on their activities by regulation are in many areas the most important constraints on their commercial activities.

1.2 The concept of authorisation

In most jurisdictions, authorisation is the basis of regulation. Authorisation means admission to a list that is maintained by a regulator. Clearly, one of the reasons for this is that at any given time regulators like to know who the participants are in the industry which they regulate. However, apart from pure bureaucratic convenience there is a more substantive reason for retaining an authorisation-based system.

Prior to the FSMA 2000 system where regulation was based on a private agreement between the regulated person and a Self-Regulatory Organisation ("SRO"), the reason for requiring a person to be a member of an SRO before he commenced doing investment business was simply that if he did not join an SRO then the rules would not apply to him. It therefore became necessary to restrict the ability to conduct investment business to those who had become members of SROs, and the fact that a person appeared on the list of members of an SRO constituted his "authorisation". The SRO model disappeared in 2001 with the implementation of the FSMA 2000, at which point the necessity for a membership-based system disappeared.

At that point it would have been possible to dispense with the system of authorisation altogether. In principle, what should matter to regulators is that their rules are obeyed. If a person acts in accordance with the rules, the regulator should be happy regardless of whether the person is named on a list. If a person acts in breach of the rules, the regulator should be unhappy. However, this approach was not adopted and the authorisation system has been largely recreated in the FSMA 2000. The reason why this was considered desirable on administrative grounds may be seen by comparing the FSMA 2000 system with the system of regulation imposed under the Consumer Credit Act 1974 ("the CCA system"). The CCA system is based entirely upon statute and regulation,³ and therefore

³ Although there is a requirement for a person to obtain authorisation from the DTI before engaging in regulated consumer credit business.

applies to consumer lenders directly as a matter of law. There is therefore no connection between authorisation and the application of the rules.

The problem which this approach creates is that making the CCA system statutory results in it being highly inflexible and deterministic. Given the scarcity of parliamentary time and parliamentary counsel, it is understandable that amendments are made only when they can no longer be avoided. More importantly, however, the only proper interpreter of statutes is the court. In the case of ambiguity, absurdity or unintended consequences, there is no competent regulator capable of handing down authoritative rulings on the relevant point. In some respects this may be desirable – for example, it would be unacceptable for a government department to be able to change primary legislation by administrative guidance. Nonetheless, where the law seeks to regulate a changing industry, changes in the law may be desirable *and* necessary in order for the law to continue to perform its function. Put another way, in order for regulation to be effective it must be changeable.

This is why the FSMA 2000 adopts a delegated structure. The Act itself imposes several primary requirements on those engaged in financial services, but it delegates power to the FSA to make other rules. However, Parliament is generally disinclined to give any regulatory agency power to make binding rules which apply to the world as a whole,⁴ and as a result has given the FSA power to make rules which apply only to authorised persons.⁵ Thus the concepts of authorisation and subjection to rules are reunited.

The practical outcome of the requirement for authorisation is a monopoly the terms of which are, loosely, that firms volunteer to undertake specific regulatory burdens in exchange for a private monopoly of the provision of a particular service.

As noted above, there is no principled reason why the grant of authorisation should not be an entirely automatic process – by submitting the application the regulated person becomes subject to the relevant rules.

⁴ Contrary to popular belief this is entirely possible under the British Constitution. Precedents extend from the Statute of Sewers of 1531, which gave the Commissioners of Sewers the power to make laws and levy taxes and embrace the Poor Law Act 1834, which conferred upon the Poor Law Commissioners an almost unrestricted power to make policy and implement it in respect of a substantial portion of the population.

⁵ Section 138, FSMA 2000.

What is the necessity for more? However, it is generally accepted that the occasion of application for authorisation is an opportunity to apply threshold tests to the applicant. The principle is that investor protection is not best accomplished by waiting for investors to be injured and then prosecuting the wrongdoer. Surgeons are not labelled as competent and incompetent solely as a result of comparing death rates due to surgery; other tests of competence are imposed before permitting them to operate. In an area where the customer is perceived as informationally disadvantaged as compared with the supplier, it is felt that the supplier, by reason of his position, has an opportunity to take advantage of the customer. The pragmatic response is that part of the regulator's authorisatory function which permits it to withdraw authorisation from those who are considered to be unfit to engage in business, and the minimum test which should be applied upon a request for authorisation is as to whether the person concerned would, if authorised, immediately qualify to lose that authorisation. The tests which the FSA is required to apply in granting authorisation are:

- (a) that the person concerned should be fit and proper (taking into account his connections, activities, soundness and prudence);⁶
- (b) that he should not be connected to another person in such a way as to impede the FSA's ability to supervise him;⁷ and
- (c) if he intends to engage in banking or deposit taking, that he is a body corporate.⁸

These statutory tests are expanded upon in the FSA's Authorisation Manual (AUTM) (which sets out detailed criteria for the grant of authorisations in specific cases) and in the Threshold Conditions (COND) section of the FSA Handbook (where the threshold conditions for authorisation are explained).

1.2.1 Authorisation and permission

The FSMA 2000 contains a single concept of authorisation – persons are either authorised or they are not. Authorisation permits a person to engage in regulated activity. However, in Schedule 2 to the Act the concept of regulated activity is subdivided into eight types of activity in

⁶ Schedule 6, para. 5, FSMA 2000.

⁷ A requirement left over from the aftermath of the BCCI collapse, and intended to catch arrangements which enable firms to distribute activities between entities in such a fashion as to inhibit regulatory scrutiny – Schedule 6, para. 3, FSMA 2000.

⁸ Schedule 6, para. 2, FSMA 2000.

respect of 14 different types of financial product. Part IV of the Act provides that the FSA can give “permission” to engage in one or more of these activities in respect of one or more of these types of products.⁹ Slightly surprisingly, the FSMA 2000 does not provide for the FSA to grant authorisation. What it does provide is that once the FSA has granted a person permission to engage in any activity, that person automatically becomes an “authorised” person for the purposes of the Act.¹⁰

The importance of this distinction is that although the FSMA 2000 prohibits *and* sanctions regulated activity which is engaged in by unauthorised persons, it neither prohibits nor sanctions activity engaged in by authorised persons outside the scope of their permission. Put simply, if a greengrocer accepts deposits, there is a statutory remedy and he is in breach of FSMA 2000; but if a stockbroker does the same thing, neither consequence follows¹¹ and his only liability is to the FSA for breaching its rules.

1.3 When is authorisation required?

Section 19 of the FSMA 2000 provides that:

“No person may carry on a regulated activity in the United Kingdom, or purport to do so, unless he is

- (a) an authorised person, or
- (b) an exempt person.”

Exempt persons are created as such by statutory instrument,¹² and the class of exempt persons contains central banks, local authorities and other governmental and quasi-governmental bodies. For everyone else, the choices are authorisation or avoidance of regulated activities.

⁹ Not all of these activities can be undertaken in respect of all the products (for example, you cannot deal in Lloyd’s syndicate memberships), but some of them are regulated even if they are engaged in respect of exclusively non-investment products (e.g. asset management). The number of possible permutations is therefore almost impossible to calculate.

¹⁰ Section 31(1)(a).

¹¹ Section 20.

¹² The Financial Services and Markets Act 2000 (Exemptions) Order 2001 SI 2001/1201.

For the purposes of the FSMA 2000, a regulated activity is an activity identified in an order made by the Treasury for the purpose under Section 22(1) of the FSMA 2000. The relevant order is the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001,¹³ universally known as the “RAO”. The RAO loosely follows the form of Schedule 2 to the FSMA 2000, but elaborates it into a complex set of rules delineating the borders both of the universe of regulated transactions and of the subdivisions used for the giving of permissions. The juridical status of Schedule 2 is one of the mysteries of the FSMA 2000. According to Section 22(2), Schedule 2 “makes provision supplementing this Section”. Since Section 22(1) is a complete order-making power, Schedule 2 appears to have no legal effect whatsoever, and acts as a sort of aide-memoire to the Treasury in their exercise of the power conferred on them by Section 22(1).

1.3.1 Deposit taking and lending

The core definition of a deposit is a sum of money paid on terms under which it will be repaid, with or without interest, either on demand or at a time agreed by the parties.¹⁴

This creates some drafting difficulties. It should be clear that a deposit and a loan are, economically, the same thing – one person gives money to another on terms that the other person will pay interest, calculated by reference to the period for which he keeps the money, and at the end of that period will give the money back. However, for regulatory purposes it is desired to draw a distinction between deposit taking and lending. Accepting deposits¹⁵ is desired to be caught within the net of regulated activities, but neither obtaining a loan, making a loan nor making a deposit are intended to be so caught. Nonetheless, it is a general principle of statutory interpretation that the words of a statute should apply to the substance of things rather than to their legal form, and the application of this principle in this context results in a wide scope. This means that on the one hand, an illegal deposit taker cannot conduct his business simply by documenting it as a series of loans made by his customers to him – if he states that he accepts such loans by way of business on a

¹³ SI 2001/544.

¹⁴ RAO Article 5.

¹⁵ Note the plural. Accepting a single deposit is not a regulated activity as the activity which is regulated is not accepting deposits per se but accepting deposits other than “on particular occasions” (see the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001, SI 2001/1177).

regular basis, he will be taken to be deposit taking. On the other hand, any commercial borrower who manages their loan financing could inadvertently be classed as a deposit taker, as could companies accepting deposits for, say, delivery of goods.

The approach which has been adopted in the legislation is to leave the core definition at its widest, and to provide a long series of exemptions which are used to pare it down to a manageable level. The most important of these exemptions are as follows:

- (a) Any deposit which is placed in consideration of the supply of property or services is exempt.¹⁶ This may appear otiose, since money which is paid in respect of, say, the fitting of a kitchen does not appear to be within the core definition of money which is paid on the basis that it will be repaid. However, in circumstances where a supplier accepts money from a customer on terms that the customer may demand it back if he changes his mind about the product,¹⁷ the exemption is needed. In the same way, and for the same reasons, a deposit made by way of security is also exempt.
- (b) Deposit taking is only regulated where it is undertaken by way of business, and deposit taking is not to be regarded as being undertaken by way of business if the person accepting the deposit does not hold himself out as accepting deposits on a day-to-day basis, and accepts deposits only on particular occasions.¹⁸ This is one of those exemptions which, although apparently widely drafted, has been construed narrowly by regulators and others. Its genesis was in the days before the debt securities exclusion had been created (see 1.3.2 below), and it was intended to give relief to UK corporates issuing securities. However, a consensus developed in the market that “particular occasions” meant “twice a year”,¹⁹ and this analysis may still be encountered.
- (c) Any deposit which is accepted as a consequence of the issue of a debt security is exempt provided that the debenture satisfies certain

¹⁶ RAO Article 5(2)(b).

¹⁷ A situation which comes up in a number of contexts – consider, for example, a season ticket where the customer has the right to surrender the ticket during its life and claim back the unused portion of the payment.

¹⁸ Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001, SI 2001/1177 Article 2.

¹⁹ Some of the more aggressive city firms used to argue that as many as four times a year was permissible.

structural criteria regarding term and size.²⁰ The reason that this exemption is required is that the issue of a debt security is otherwise economically identical to the making of a deposit by the noteholder with the note issuer. For many years prior to the implementation of the RAO, UK companies had complained that the lack of an explicit exemption to this effect prevented them from raising money in the Eurobond markets unless they established costly overseas issuing structures.

- (d) Any deposit where the depositor is a bank or institution carrying on a business of lending money is exempt.²¹ This has the effect of preventing loans made by lending businesses from being treated as illegal deposits in the hands of borrowers. It also means that it is possible to conduct a completely unregulated deposit-taking business in the UK provided that deposits are taken exclusively from banks and professional money-lending institutions.
- (e) Any deposit received by a person conducting investment business is exempt provided that it is received by him in the course of conducting that business.²² This provision is relevant only to the extent that the definition of deposit taking used in the FSMA 2000 forms the basis of the permission regime – thus, a deposit accepted by an investment firm which did not have permission to accept deposits would be a contravention of the terms of that firm's permission, despite not being a contravention of the FSMA 2000.
- (f) Any deposit received by a solicitor and paid by him into a client account maintained under the rules of the Law Society is exempt.²³
- (g) Any deposit received in exchange for the issue of electronic money is exempt. This is because the activities of electronic money institutions are regulated under Chapter IIA of the RAO.

1.3.2 Investments

In order to define investment business it is first necessary to define investments. The list of "investments" defined as such is set out in Part III of the RAO. It includes:

²⁰ RAO Article 9. The conditions are that the debt security has a maturity of more than one year and is issued on terms that it may only be transferred in units of £100,000 or greater.

²¹ Or for that matter a government body, central bank or supranational – RAO Article 6.

²² RAO Article 8.

²³ RAO Article 7.

- (a) Shares of all forms, including interests in the capital of unincorporated bodies.²⁴ Share accounts with building societies, credit unions or equivalent holdings with industrial and provident societies are excluded from this definition.
- (b) Debt securities. There is considerable uncertainty about what this simple-sounding phrase actually means. By common consent it must be wider than negotiable instruments, since the majority of the instruments traded in the debt markets do not satisfy the technical criteria to be bills of exchange.²⁵ However, once these formal criteria are exceeded, the document concerned becomes no more than a written memorandum evidencing the existence of an agreement to pay interest and principal by the borrower, and as such impossible to distinguish from a memorandum, bank statement or documentary IOU. The RAO addresses this issue by setting its core definition as widely as possible (“Any . . . instrument creating *or acknowledging* indebtedness” (emphasis added))²⁶ and then carving out:
 - (i) banknotes;
 - (ii) bank statements;
 - (iii) cheques and bankers drafts;
 - (iv) bills of exchange;²⁷
 - (v) letters of credit and documentary credits;
 - (vi) receipts issued for payments in respect of the supply of goods and services.

It should be noted that although the definition of shares in the RAO focuses on legal ownership, the definition of debt securities focuses on documents (“instruments”). It was therefore necessary to extend the meaning of the latter to ensure that uncertificated securities were included in it.²⁸ For some mysterious reason it was felt that this definition was insufficiently general to catch government debt securities, which are given a separate article of their own.²⁹ In addition to the types of instruments excluded above, National

²⁴ But not, curiously, UK unincorporated bodies – RAO Article 76(1)(b).

²⁵ Strictly speaking some non-bills of exchange are also negotiable instruments – see *Bechuanaland Exploration Co. v London Trading Bank* [1898] 2 QB 658 and generally Gleeson, S (1997) *Personal Property*, London: Sweet & Maxwell, chapter 20.

²⁶ RAO Article 77(f).

²⁷ Except bills of exchange accepted by a banker (RAO Article 77(2)(b)). Since a bill will only be dealt in on the London bill market if it has been accepted by a banker, this somewhat inelegant approach is nonetheless effective.

²⁸ Uncertificated Securities (Amendment) (Eligible Debt Securities) Regulations 2003, SI 2003/1633 regulation 15, Schedule 2, para. 8.

²⁹ Article 78.

Savings Certificates and similar instruments are also excluded from the scope of the regime.³⁰

- (c) Instruments giving entitlement to subscribe for investments.³¹ This definition was created in the FSAct 1986 to catch the kind of warrant issued by a company which entitles the holder to subscribe for new shares in it at a pre-set price. This kind of warrant is to be distinguished from the kind of warrant which entitles the holder to buy an existing share from the warrant issuer at a pre-set price. The RAO makes this distinction by providing that an instrument only falls within this category if it is a warrant to “subscribe for” securities³² (i.e. to buy them new from the issuer) as opposed to a warrant to buy existing securities from a third party. The reason that so much effort is put into making this apparently minor distinction is that this type of warrant is broadly excluded from the class of “derivatives” (see (f), (g) and (h) below).³³
- (d) Certificates representing securities.³⁴ This class includes certificates which give the holder rights in respect of shares or debentures,³⁵ provided that the specific certificate concerned gives rights to securities issued by the same investor. What this is getting at is depository receipt and similar arrangements, where the instrument itself acts as a simple proxy for a different underlying instrument.³⁶
- (e) Units in a collective investment scheme. The term “collective investment scheme” casts a long shadow. Its primary meaning is “investment fund”. However, the class of investment funds is a broad one, involving a wide variety of legal structures and investment models. The definition is therefore broadly expressed in a semi successful attempt to catch any arrangement which performs the economic function of an investment fund. The core of the definition is therefore that a collective investment scheme means any pooling arrangement whereby a number of investors put money into a fund which is managed centrally by a separate, independent manager. Such structures generally involve the investor acquiring a fund unit which he can realise either by selling or (more commonly) by

³⁰ Article 78(2)(b).

³¹ RAO Article 79.

³² “Securities” in this context meaning shares and debt securities only.

³³ This is the effect of Article 79(3).

³⁴ Article 80.

³⁵ Or warrants to subscribe.

³⁶ In a typical depository receipt arrangement a custodian bank will accumulate a holding of a particular security and then issue securities itself carrying an entitlement to those underlying securities.

redeeming it with the fund in exchange for a proportionate share of the funds investments. This definition effectively catches investments in regulated and unregulated funds; thus, units in onshore unit trusts and investments in offshore hedge funds are generally all within the class of units in collective investment schemes.

The problems which arise with the definition are perhaps predictable. Because the definition is sufficiently broadly drafted to catch all possible varieties of investment fund, it also catches a wide variety of other arrangements which are clearly not investment fund arrangements. The more important of these (for example joint ventures, leasehold companies, arrangements between group companies, timeshares, securities clearing arrangements) are explicitly excluded from the definition by statute.³⁷ However, a number of problematic areas remain. Some of the more important of these are as follows:

- (i) Investment companies. Any company is, in theory, within the core definition of a collective investment scheme. This issue is addressed by an exclusion to the effect that “closed-ended” companies are not collective investment schemes. Closed ended, in this context, means that the investor has no continuous right to redeem his shares from the company at net asset value.³⁸ On this basis most commercial companies are excluded from the definition. However, problematically, investment trusts (that is, investment vehicles whose shares are listed and traded on the Stock Exchange) also fall within this definition. There is thus at least one significant class of investment fund which falls outside the definition.
- (ii) Asset linked notes. A note whose return is linked to a pool of assets (for example a simple FTSE-linked note) may fall within the definition of a collective investment scheme. Most notes are excluded by the principle that a scheme is defined as being an arrangement with respect to identifiable property – thus a note which pays a return based on a mathematical formula and which is not related to the value of specific identifiable property in the hands of the note issuer or a third party, is generally not a collective investment scheme. However, this somewhat notional distinction requires careful drafting in order to comply with it, and the risk is ever present.

³⁷ The Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001, SI 2001/1062.

³⁸ Section 236 FSMA 2000.

- (iii) Asset pooling arrangements. Assets are regularly pooled for management purposes without any investment intention – thus a number of racehorse owners might place their horses with a single trainer. Mere pooling of assets, without more, does not create a collective investment scheme. However, any financial pooling of the proceeds of ownership creates risk in this direction. This risk is lower for a single, identifiable asset which on its own creates an identifiable income stream.³⁹ However, where income is less easily allocated to a specific asset (for example, where neighbouring farms are farmed together and the crops sold as a whole) the risk becomes more serious.
- (f) Options. An option is defined at common law as a contract between two persons by which one of them makes an offer to the other and agrees for good consideration that the offer will remain open for a specified period of time and will not be withdrawn during that time. Options are rare in ordinary life but common in many sorts of ordinary commercial transaction (including in particular real-estate transactions). The RAO therefore provides that an option will fall within the class of regulated investments only if it is an option in respect of:
 - (i) securities;⁴⁰
 - (ii) derivatives;⁴¹
 - (iii) an investment assurance policy;⁴²
 - (iv) currency;
 - (v) certain precious metals.⁴³These criteria are applied whether or not the option is exchange traded. However, since most exchange-traded options do not fit within the legal definition of an “option” this point is rarely significant.
- (g) Futures. A future is simply a contract of sale whereby delivery is to be made at a future date at a price agreed when the contract is made.⁴⁴ It should be clear from this that the vast majority of

³⁹ Or, as is usually the case with racehorses, not.

⁴⁰ Including shares, debt securities, warrants to subscribe, certificates and units in collective investment schemes (RAO Article 83 and Article 3).

⁴¹ That is, options, futures or contracts for differences. An option over an unregulated option is not a regulated option (Article 83(a)), and an option over a regulated option is a regulated option (Article 83(d)).

⁴² That is, an insurance policy which performs the function of a savings product.

⁴³ Palladium, platinum, gold, silver.

⁴⁴ Article 84(1). A price is “agreed” even if the amount is not agreed – the specification of a mechanism by which the price can be established at a particular future date constitutes agreement of the price for this purpose (Article 84(8)(a)).

contracts made in commerce are futures within a strictly technical definition. There is therefore no structural distinction between a contract between an exporter and an importer to pay for goods delivered at a future date on that date and the activity of a speculator seeking to profit from future price movements. However, regulatory policy seeks to regulate the activity of the speculator but not the contract between an exporter and an importer. The mechanism employed is a cumbersome one in that it purports to distinguish between “investment” and “commercial” futures, basing the distinction upon the intentions of the parties when entering into the contract. In simple cases this can be deemed – thus every contract concluded on an investment exchange (or on exchange terms) is deemed to be an investment contract, and every contract which provides for delivery within seven days of the making of the contract is deemed to be for commercial purposes, but outside these two classes the determinant is intention, and intention is both imponderable and generally unprovable. The RAO therefore provides a series of “indications”⁴⁵ as to whether a particular futures contract should be taken to have been intended by the parties to have been made for commercial or investment purposes. These are:

- (i) If one of the parties is a producer or user of the subject matter of the contract,⁴⁶ or settlement is intended to be by physical delivery of the subject matter of the contract, then the contract is likely to be regarded as a commercial contract. If not, the contract is likely to be regarded as a regulated contract.
- (ii) If the terms of the contract are privately agreed between the parties the contract is likely to be regarded as a commercial contract. If the price, delivery date, lot size or terms are set by reference to market standards this will negate any assertion by the parties that the terms are privately negotiated.
- (iii) By extension, if the contract is expressed to be on market terms, or to be cleared through an exchange or clearing house, or if there are arrangements for the payment of margin over the life of the contract, then the contract will be taken to be a regulated contract.

Indicia may be helpful after the event, but they are distinctly unhelpful in determining in advance of a particular transaction whether or not it will be subject to regulation. The further problem

⁴⁵ Article 84(5) to 84(7).

⁴⁶ Since banks are users of foreign currency, it has long been argued that foreign exchange futures between banks are unregulated.

is that, given the economic similarities between futures contracts for a particular asset, options over that asset and swaps priced off a reference price derived from the value of the asset, it makes no sense that the three classes of contract should be treated differently for regulatory purposes. In particular, it makes no sense for certain futures (e.g. grain futures) to be regulated where an equivalent option would be unregulated (or vice versa).

- (h) Contracts for differences. Article 85 of the RAO catches two types of investment:
- (i) "contracts for differences"; and
 - (ii) any: "contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or in an index or other factor designated for that purpose in the contract"⁴⁷

in each case where the contract is to be settled by the payment of money rather than the delivery of property.⁴⁸

The reason that the distinction is made is that contracts for differences have been around in the UK for well over a century. It seems that for as long as there has been a London Stock Exchange, brokers and customers have been entering into purported transactions in which neither side intended that stocks should be purchased or delivered, but that "differences" only should be paid.⁴⁹ These contracts gave rise to much litigation since the old rule was that contracts where neither party intended to accept delivery of property were gambling transactions and were therefore void under the gaming laws⁵⁰ unless the documentation provided for

⁴⁷ Despite the relative youth of the derivatives market, this formulation is of respectable antiquity. It first appeared in statute Section 26(1) of the Prevention of Fraud (Investments) Act 1958, the predecessor of the FSMA 2000, but its first appearance in case law dates back to 1848.

⁴⁸ Contracts which involve the delivery of property are excluded from Article 85 by Article 85(2)(a), and are therefore thrown neatly into Article 84.

⁴⁹ See *Universal Stock Exchange v Strachan* [1896] AC 166 for a description of such an operation. The activities of Universal Stock Exchange, as described in the summing-up of the judge of first instance in that case, bear a remarkably close resemblance to the activities of modern financial bookmakers as described in *City Index Ltd v Leslie Times*, October 3 1990, [1992] QB 98 (CA).

⁵⁰ *Cholmley v Lawrence* (1848) 11 LTOS 410; *Universal Stock Exchange v Strachan* [1896] AC 166; *Thacker v Hardy* (1878) 4 QBD 685; *Grizewood v Blane* (1852) 11 CB 538. The problem of the application of the gaming laws has been addressed by Section 412 of the FSMA 2000.

actual delivery.⁵¹ These contracts therefore became known as “contracts for differences”. On the basis of the case law it is probable that the term “contract for differences” is only properly applicable to a contract where the underlying reference asset is the price of a security and the amount to be paid under the contract is the difference between the price of the security on the date the contract was entered into and the price on the date it matured.

If this is correct then the class of contracts for difference is wholly subsumed into the larger class, which catches any contract that requires a payment to be made on terms that the amount of the payment due may vary by reference to any extraneous factor. This is a very wide definition. It succeeds in catching all of the over-the-counter (“OTC”) derivatives which have thus far been invented, with the interesting exception of binary derivatives – that is, derivatives of a form which oblige one party to pay out, say, £1 if an event occurs and nothing if it does not. It is argued that such derivatives are not caught by Article 85 as the amount due under them does not vary according to any factor but is absolutely determined at the date of inception. This is the argument which is generally used by the FSA to support its view that ordinary betting is outside the scope of the FSMA 2000.⁵² It should also be noted that index-linked deposit accounts, where the interest rate payable on the account varies according to some external rate, are expressly permitted.⁵³

1.3.3 *Dealing as principal in investments*

The financial markets exist to enable investors to buy and sell investments, and the usefulness of a financial market is therefore a function of ease of access to it. It therefore seems reasonably clear that investors per se should not be required to be authorised before they can invest. Market participants, however, should be regulated. The fundamental difficulty faced by regulators in this respect therefore relates to how to make a distinction between investors and market participants. The easy distinction which existed many years ago between investors who dealt as principals and market participants who dealt as agents has long gone –

⁵¹ *Universal Stock Exchange v Stevens* (1892) 66 LT 612. An option to take delivery was insufficient to save the contract from the taint of gambling; *Re Gieve* [1899] 1 QB 794.

⁵² However, spread betting (i.e. betting where the amount won is in proportion to the increase in a particular factor) is within the scope of regulated activity (*City Index Ltd v Leslie* [1992] QB 98 (CA)).

⁵³ Article 85(2)(b).

in modern markets many, if not most, market participants deal in the market in their own names. Thus, the core definition of investment dealing must capture these active dealers whilst avoiding requiring end investors to become authorised.

The mechanism which the FSMA 2000 uses to achieve this is a broad inclusion accompanied by numerous exemptions. Article 14 provides that buying, selling, subscribing for or underwriting securities or derivatives is a regulated activity. Articles 15 and 16 go on to construct a substantial carve-out which probably covers 99 per cent of the transactions to which Article 14 would otherwise apply. Transactions are divided into two types: transactions in securities and transactions in derivatives – different carve-outs are provided for each.

- (a) For securities transactions,⁵⁴ the test is based on regular dealing. A person who deals in a particular security is assumed not to be conducting a regulated activity unless he:
 - (i) holds himself out as prepared to buy that security on a continuous basis at prices determined by him (i.e. acts as a market maker); or
 - (ii) holds himself out as engaging in the business of buying those securities with a view to selling them; or
 - (iii) holds himself out as being in the business of underwriting investments; or
 - (iv) regularly solicits members of the public⁵⁵ to enter into securities transactions with him.
- (b) For derivatives transactions,⁵⁶ the test is based on the identity of the counterparty. The policy is that if two unregulated investors sell shares between themselves, that is properly an unregulated transaction, but if the same investors enter into a derivative transaction between themselves, that is properly a regulated transaction. Thus a person who enters into a derivative transaction engages in regulated business unless he does so either:
 - (i) with an authorised person;⁵⁷ or
 - (ii) with an overseas person whose ordinary business is akin to that of an authorised person.⁵⁸

⁵⁴ Article 15.

⁵⁵ For this purpose “the public” means, broadly, people other than authorised, exempt or overseas persons (*see* RAO Article 152 for the full list).

⁵⁶ Article 16.

⁵⁷ Article 16(a).

⁵⁸ Article 16(b).

This example also neatly illustrates the fact that what is regulated is not the transaction itself but the act of engaging in the transaction – if unregulated A enters into a derivative transaction with regulated B, then B is engaging in regulated business but A is not.

The other principal exclusions are those relating to the origination of securities transactions. By Article 18 the issue by a company of its own shares or debentures⁵⁹ is excluded from the scope of regulated activities.⁶⁰ and by Article 17 the accepting⁶¹ of an instrument creating or acknowledging indebtedness is also so excluded. The necessity for Article 17 seems to be another manifestation of the fact that the definition of debt securities in Article 77 includes a number of memorandum documents which are not generally regarded as securities, and entry into such documents therefore needs to be excluded. In practical terms what Article 17 does is to ensure that a lender does not become a dealer in securities by reason of signing a loan agreement.

1.3.4 Arranging transactions

The Articles of the RAO which relate to arranging transactions are probably the most difficult to construe. The reason for this is that what is sought to be captured is the idea of proximity to a transaction – persons who, although they are not directly engaged in the transaction, are nonetheless sufficiently close to it to bear regulatory responsibility for it.

The concept of arranging is addressed in two ways: a specific and a general provision.

- (a) The specific provision is that making arrangements for another person to buy, sell, subscribe for or underwrite a particular investment is regulated business.⁶² This is reasonably easy to understand – if a person takes steps to bring about a specific transaction in which an identified person deals in an identified investment, then

⁵⁹ Or share warrants or debenture warrants.

⁶⁰ By Article 18A dealing by a company in its own shares is also exempted.

⁶¹ It is genuinely infuriating that a term which has an accepted technical meaning in the field of negotiable instruments should be used for an entirely different purpose in a definition which applies to, *inter alia*, negotiable instruments. However, Article 17(2), which provides that “the reference to a person accepting an instrument includes a reference to a person becoming a party to an instrument otherwise than as a debtor”, has this effect.

⁶² Article 25(1).

he can be said to have an involvement in the transaction. The specific provision does not apply where the arrangements concerned did not or would not bring about the deal concerned. Thus where a person makes arrangements in respect of a deal, but where something further is needed on top of those arrangements to bring about the deal, the person's arrangements do not fall within this definition. This can be summarised as follows: in order to arrange a specific transaction in such a fashion as to require regulation, the arranger must lead both parties all the way to the transaction.

- (b) The general provision is in many respects more challenging. It is to the effect that making arrangements whose purpose is that those who participate in them will buy, sell, subscribe for or underwrite investments is also a regulated activity. This catches the operators of electronic dealing networks and other market service providers (although not telecoms systems operators⁶³). The point here is that although these persons cannot be said to arrange specific individual transactions, without their input the transactions concerned would not have been entered into, or would have been entered into in a different way. Consequently, their involvement with the transaction satisfies a "but for" test (i.e. but for their involvement there would have been no transaction) and they should therefore be regulated. A specific exemption is provided for those who indirectly facilitate transactions by providing finance for them.⁶⁴

The general provision is possibly a broader assertion of the scope of responsibility of the regulator than is encountered anywhere else in the world, and the FSA has in the past been somewhat defensive about it. The broad justification of this extension of the regulatory system is that it enables the regulator to control market infrastructure providers whose activities can determine every aspect of transactions done through them even though they may never be directly responsible for a single transaction. However, at the extreme it catches not only service providers but also computer system vendors, fax-paper suppliers and most of the coffee shops in the City, all of whom provide services but for which transactions generally might not be made.

⁶³ Article 27. It may be felt that the fact that it is necessary to exempt the telephone company from the scope of this definition might be a good leading indicator that it is perhaps unjustifiably wide.

⁶⁴ Article 32.

The exemptions provided in respect of arranging are numerous, as might be expected. An exemption is provided for arranging transactions with authorised persons generally as long as the agent is providing a purely ministerial function, does not receive a pecuniary reward, and the transaction is being entered into on the basis of investment advice received from a regulated person. In the same way, making arrangements will not fall within the general provision for arranging if the effect of those arrangements is to introduce a person to a regulated person for the purpose of the regulated person giving independent advice.⁶⁵ Likewise, arranging the issue of shares⁶⁶ or debentures⁶⁷ by a company is excluded.

Exchanges, custodians and clearing and payment systems all provide services which to one degree or another fall within the general provision as regards arranging transactions. The FSMA 2000 provides for exchanges and clearing houses to be regulated separately,⁶⁸ but this is not a requirement and it is perfectly possible to operate an exchange or a clearing house under a general authorisation. Providing custody or settlement services is regulated separately by Article 40 of the RAO which includes safeguarding and administering any portfolio of assets which does include or may include a security or derivative. “Administering” in this context must involve more than merely providing information as to the composition of the portfolio⁶⁹ or passing on documents relating to it.⁷⁰ Further, by Article 45, putting instructions into the Crest system on behalf of a customer is itself a regulated activity. The effect of these two Articles is that any person providing settlement or custody services must be regulated either as a clearing house or as a custodian.

A specific exemption is also provided for persons who act as agents for others in the obtaining of financial services. The idea is a simple one – if one person obtains financial services for the benefit of another, this should be permissible provided that the intermediary is acting as a mere conduit. A good example might be a trustee of a charitable venture seeking professional advice on behalf of the venture as to the investment of its spare cash. This activity is exempted, provided that the transaction is entered into on the basis of advice given by a regulated person, that the agent has not given advice as to the transaction, and that the agent

⁶⁵ Article 33.

⁶⁶ Article 34.

⁶⁷ Article 31.

⁶⁸ Part XVIII.

⁶⁹ Article 43(a).

⁷⁰ Article 43(c).

has not received a fee from any person other than his client in order to bring the transaction about.

1.3.5 Investment management

The definition of investment management for regulatory purposes is surprisingly wide. As might be expected, it catches the management of assets belonging to another person in circumstances involving the exercise of discretion.⁷¹ However, it catches not only the management of portfolios of investments, but also the management of assets of any description where the portfolio concerned could include investments. Thus, it is only discretionary management arrangements where the assets concerned could never under any circumstances include investments which are usually outside this provision. Thus, if a person manages a racehorse on behalf of colleagues, but has power to put spare cash in a money market investment pending its investment (in the form of food) in the horse, he will be engaging in regulated business.

1.3.6 Investment advice

The definition of the giving of investment advice as a regulated activity is reassuringly narrow. There are very few observations made in commercial discourse, particularly in the form of comment on the economy, the relative performance of particular companies or the financial markets, which could not be construed on a generous interpretation to be investment advice. The RAO's definition of the term therefore confines itself to advice which is given to an investor in his capacity as such, and which addresses the merits of his buying, selling, subscribing for or underwriting a particular investment.⁷² Thus, advice which is addressed generally is outside the scope of the definition, as is advice which is addressed to the state of the markets generally.

The most substantial exclusion which is needed in this context is one which arises as regards the media. Newspapers and other mass communicators never tire of explaining (sometimes in great detail) exactly what will happen in the future, and this tendency is as prevalent in the financial pages as in the editorial columns. Clearly it would be unwelcome to prohibit (or at least severely circumscribe) financial journalism, and the compromise which has been reached is set out in Article

⁷¹ Article 37.

⁷² Article 53.

54. This provides that a newspaper, radio programme or similar may give advice provided that the principal purpose of the publication as a whole is not to do so. This has the effect that specialist investment publications which exist wholly for the purpose of giving investment advice must become authorised, but that general publications may carry financial sections provided that these sections do not become a substantial part of the publication as a whole. The FSA is given a power to issue certificates to the effect that particular publications do not contravene this requirement, and most newspapers have such certificates. The broad criteria used by the FSA in respect of such certificates are that the publication should address reporting generally, and that the proportion of the publication which relates to financial issues should not exceed a small fraction (conventionally 10 per cent) of the totality of the material contained in it.

1.3.7 Collective investment schemes

There are four activities in relation to collective investment schemes which are regulated:

- (a) establishing a scheme;
- (b) operating a scheme;
- (c) winding up a scheme; and
- (d) acting as trustee, depository or sole director of a scheme.

There is seldom any ambiguity as to whether these activities are in fact being performed; the question being almost invariably one as to whether the arrangement concerned is in fact a collective investment scheme.

1.3.8 Non-financial transactions involving investments

Non-investment transactions may well involve investments. A deal whereby a person pays for the installation of his kitchen by handing over debt securities instead of cash may seem improbable, but in the commercial world such transactions are occasionally encountered. In particular, investment businesses structured through a series of holding companies will only distinguish between holdings of assets and holdings of the share capital of the company holding those assets (if at all) for tax purposes. It is therefore necessary to exclude such “mixed” transactions from the scope of regulated activity. This is done by a small suite of exemptions. The most general is Article 68, which broadly exempts any transaction where the purpose of the transaction is the sale of goods or the supply of services by a supplier to a customer. However, there is also a specific exemption which covers transactions which constitute the sale

of shares in a company where the primary aim of the transaction is the sale of control of the company rather than the sale of individual investments.⁷³ This is a difficult exemption to construe, as the distinction between an acquisition for the purpose of control and an acquisition for the purpose of investment is by no means clear. The rule of thumb which is applied⁷⁴ is that where the sale is between a single buyer and a single seller⁷⁵ and results in the buyer acquiring more than 50 per cent of the share capital of the company, the transaction will be regarded as outside the scope of regulated business.

1.3.9 Corporate groups and risk management

There are certain areas of financial activity which properly fall wholly outside the scope of regulated business. The most important of these is the suite of exemptions which apply to transactions within groups of companies. Within a corporate group, companies may deal in investments with each other⁷⁶ and place deposits with each other⁷⁷ without requiring authorisation. In practice, the reason that corporate groups wish to engage in investment business with each other is to enable the financial activities of the group to be concentrated in a single "treasury" company, which will manage the whole of the group's financial position. As a result, cash and investments acquired by other group members will be transferred to this company and then invested in the market. This arrangement usually gives rise to some concerns as to the position of the treasury company, which may find itself managing a substantial portfolio of assets. The issue is that a treasury company which is unregulated may either engage in investment dealing sufficiently frequently to imperil its investor status, or wish to enter into derivatives transactions with other unregulated entities.

The question of whether such an entity should be regulated is a much-discussed point with no clear answer. It is clear that a sufficiently large treasury company could find itself engaging in a business which is almost identical to that engaged in by investment banks and the like. However, there is a difference in kind between the activities of a market trader, which is seeking to make profits by dealing, and the activities of a treasury company, which is seeking to manage financial risks incurred

⁷³ Article 70.

⁷⁴ Article 70(2).

⁷⁵ Or, in each case, a group of connected individuals.

⁷⁶ RAO Article 69.

⁷⁷ RAO Article 6(1)(c).

in the course of a non-financial business. However, it should be clear that a treasury company may well find itself taking an approach to its trading activities which is functionally identical to that of a securities dealer, and there are many group treasury companies which are run as profit centres in their own right. There seems to be no reason why such companies should not be regulated in the same way as other investment firms. The approach which the RAO seeks to adopt is to exempt trading by unregulated entities which is entered into for the purposes of limiting the extent to which a (non-investment) business will be affected by an identifiable risk arising out of that business.⁷⁸ This exemption has two limbs. As regards securities trading, it means that a company which is hedging risk does not need to concern itself with the question of whether it is holding itself out as prepared to deal continuously, or with any of the other issues identified above. As regards derivatives trading, a company which is hedging risk is not bound by the rule that an unregulated person entering into a derivative must do so with a regulated person.⁷⁹ Unregulated companies are also permitted to arrange transactions for risk management purposes between external entities and other group companies.⁸⁰

1.3.10 Professionals

Many accountants, lawyers, management consultants and other professionals give advice which touches to some degree on the business of investments or assists in the arranging of transactions which may be transactions in investments. The FSMA 2000 contains a set of provisions⁸¹ whose effect is that the members of certain professional bodies designated by the FSA are exempted from the general prohibition provided that their involvement in such transactions is in the course of the provision by them of their relevant professional services and is not separately remunerated. However, this leaves a residual problem for those whose professions are not regulated by such professional bodies. An exemption is given in the RAO in respect of activities which are provided as a necessary part of other services supplied in the course of that business,⁸² but the requirement that the services be “necessary” means that the exemption is of limited usefulness.

⁷⁸ Articles 19 and 23.

⁷⁹ Or an overseas cognate of a regulated person.

⁸⁰ Article 23.

⁸¹ Part XX, Sections 325–333.

⁸² Article 67.

1.3.11 *Agreeing to carry on activities*

The policy aim of a regulator is to prevent investors dealing with unregulated persons rather than simply to punish those who engage in unregulated activity. For this reason, a prohibition which took effect only when the business concerned had been done would leave the regulator unable to take pre-emptive action. As a result, the RAO contains a provision⁸³ to the effect that agreeing to engage in a regulated activity is itself a regulated activity. The effect of this is that if an unregulated person agrees to enter into an investment transaction with another, he is in breach of Section 19 and liable to regulatory enforcement action from the moment that he enters into the agreement. It may be noted that the test here is the agreement alone and is not intent based – if the RAO were not drafted in this way, an unregulated person who agreed to engage in investment activity would have a complete defence if he could prove that he had no intention of performing his obligations under the agreement. One interesting exception from the agreeing rule is the performance of any of the activities relating to collective investment schemes. Thus it is not contrary to Section 19 for an unauthorised person to agree to establish or to become the operator of a collective investment scheme at a future time. The reason for this is that new asset managers are frequently established alongside the funds which they are to manage. If fund establishment and operation were not excluded from Article 64, an asset manager would be obliged to complete the process of obtaining authorisation himself before commencing the business of setting up the fund which he intends to manage. The current structure permits the two activities to proceed in parallel.

1.3.12 *Payment systems*

Broadly speaking, the operation of a payment system is wholly outside the scope of regulated activities, and the various UK payment systems themselves operate without authorisation. However, participation in a payment system usually involves authorisation. The reason for this is that the participants in a payment system are engaged in a process where a payment on behalf of a customer at one time and recouped from the customer at a different time. If the payment into the system is made by the system participant after it has been put in funds by its customer, the participant will be engaged in deposit taking. If it is made before the participant has been put in funds by the customer (a considerably less

⁸³ Article 64.

common system), the participant will be engaged in the provision of credit. Thus the operation of a payment system is not a regulated activity, but participation in such a system usually is.

There is one curiosity as regards the regulation of payment systems and that is the rules relating to electronic money (“e-money”). The regulation of e-money is unnecessarily complex and is the fruit of an badly thought-out directive passed through the EU at the height of the dot-com boom.⁸⁴ E-money is defined as monetary value represented by a claim on the issuer which is stored on an electronic device, issued on receipt of funds and accepted as a means of payment by a person other than the issuer. Issuing electronic money is a regulated activity.⁸⁵

It is probable that what the Commission sought to achieve with the e-money directive was to liberate those providing this service from the necessity to become authorised as banks. The means adopted to achieve this involved the creation of a separate e-money regulatory regime intended to exist in parallel to the banking regulatory system – for this reason, credit institutions are prohibited from becoming authorised as e-money institutions but must rely on their deposit-taking and consumer credit authorisations to conduct this type of business. Sadly, the regime thus created was even more onerous than the banking regime, and it has languished almost unused on the statute book since its creation. Two curiosities within the regime are worthy of comment. First, the RAO contains a provision empowering the FSA to make regulations prohibiting the issuing of e-money at a discount,⁸⁶ and second, the RAO contains a large and almost entirely redundant series of provisions permitting the FSA to certify various small⁸⁷ schemes as being exempt.

1.4 The consequences of non-authorisation

A person may breach the FSMA 2000 without conducting any investment business at all. By Section 24 it is a criminal offence for an unauthorised person to hold himself out in a manner which indicates that he is an

⁸⁴ 200/46/EC.

⁸⁵ Article 9B.

⁸⁶ Article 9H. These rules have been made, and can be found in the FSA’s E-Money Sourcebook ELM 4.4.

⁸⁷ Small in this context means total issue per customer €150, issuance which is redeemable only with subsidiaries of the issuer or accepted by fewer than 100 persons located within four square kilometres.

authorised person. This requirement is a continuation of the former Banking Act 1987 provision that restricted the use of the word "bank" to authorised banks.⁸⁸ Compliance with this rule requires a certain amount of careful drafting, since whereas the use of the word "bank" is a fairly easy thing to assess, the question as to whether any particular form of words is capable of giving the impression that the person described is authorised under the FSMA 2000 is a much more nebulous matter.

The offence as created is almost certainly an offence of strict liability.⁸⁹ Since it is created by an unconditional ascription of liability followed by the provision of an express defence of ignorance. This form of drafting must necessarily create an offence of strict liability, since in any other case the statutory defence provided would be wholly or partly redundant.⁹⁰ Thus if the court decides that the statement or action is capable of being interpreted as indicating that the person making or doing it is authorised, the fact that it was not the intention of the person concerned to hold himself out in this way does not provide a defence. The specific defence which is provided is exceptionally narrow as it applies only if the accused can prove that he took *all* reasonable precautions and exercised *all* due diligence to avoid committing the offence. Reasonable precautions and reasonable due diligence are, it appears, insufficient.

Where an unauthorised person actually engages in regulated activity in the UK without authorisation, he contravenes Section 19. Contravention of Section 19 has two consequences. The first of these is that the person concerned commits a criminal offence. The second is that the transaction concerned is potentially void.

Voiding contracts is a draconian sanction. At common law the preference of the courts is to maintain contracts where possible, and to take the view that the function of most statutory prohibitions is to enable the imposition of sanctions only.⁹¹ The Court of Appeal considered the

⁸⁸ With certain exceptions – sperm banks, bottle banks and clothing banks tended to go unprosecuted.

⁸⁹ The nearest authority appears to be *Wings Ltd v Ellis* [1985] AC 272, where a similar offence created by the Trades Descriptions Act 1968 was held to be an offence of strict liability.

⁹⁰ Card, R et al. (1995) *Card, Cross and Jones Criminal Law*, London: Butterworths at page 115.

⁹¹ Per Devlin J in *St. John Shipping Corp. v Joseph Rank Ltd* [1957] 1 QB 2678.

point in *Phoenix General Insurance Co of Greece S.A. v Halvanon Insurance Co Ltd*⁹² in relation to Section 2 of the Insurance Companies Act 1974, one of the forerunners of Section 19, and emphasised the distinction between statutes which merely prohibit the entering into of particular classes of contract and statutes which prohibit not only entry into a contract but also the performance of that contract. It was held that because the prohibition contained in the Insurance Companies Act 1974 was of the latter type then the contract was completely void and could never have existed. However, the court held that, had the prohibition in the Act been of the first type, then the criminal offence would still have been committed but the resulting contract would have been valid.⁹³

The difficulties created by avoiding language in statutes are well known. The equivalent provisions in the Consumer Credit Act 1974 have the effect that where a lender has lent money using documentation which does not comply exactly with the requirements of the consumer credit system, he is for all practical purposes unable to recover it. This may, in the circumstances, appear to be a just result. However, in the opposite case – where a person takes deposits illegally – the position is clearly different, and in the Banking Act 1987, which rendered unauthorised deposit taking a criminal offence, it was expressly provided that any unauthorised person who accepts a deposit commits a criminal offence, but that the fact that a deposit has been taken in contravention of the prohibition “shall not affect any civil liability in respect of the deposit or the money deposited”. This provision has been held⁹⁴ to preserve the validity of the deposit contract. The civil sanction element of the legislation was that the depositor was entitled to recover the amount deposited immediately along with profits made from such deposits.⁹⁵

The prohibition contained in Section 19 of the FSMA 2000 is accompanied by a range of provisions as regards its voiding effect. As may be expected, where a person engages in a regulated activity (other than accepting deposits) in breach of Section 19, the resulting agreements are unenforceable against the other party,⁹⁶ and the other party is entitled to recover from him any money or assets transferred to him and compensation in

⁹² [1988] 1 QB 216.

⁹³ Followed in *Re Cavalier Insurance Co. Ltd* [1989] 2 Lloyds Rep 430.

⁹⁴ *Box, Brown and Jacobs v Barclays Bank* [1998] Lloyds Rep Bank 185.

⁹⁵ Sections 48 and 49 of the Banking Act 1987.

⁹⁶ Section 26(1). Note that this means that the agreement cannot be enforced by a third party to whom the benefit of the agreement has been transferred without notice of the defect.

the tort of breach of statutory duty. If the regulated activity complained of is the accepting of deposits, then the transaction is not void and the only right conferred upon the investor is to have his money repaid immediately.⁹⁷ The FSMA 2000 contains provisions which permit a court to make an order reinstating the transaction if it is satisfied that the person carrying on the activity reasonably believed that he was not contravening the general prohibition.

More difficult is the position which arises where the illegal regulated activity concerned consisted of the arrangement of a transaction between two other persons. On one hand, it would seem unjustified to give either of the participants in the transaction a right to escape from it just because it was arranged by an unauthorised person. On the other hand, to do nothing would be perceived as unduly beneficial to unauthorised arrangers. The slightly uncomfortable compromise is that contracts (other than deposits⁹⁸) arranged by unauthorised persons are void only if one of the parties is itself a regulated person.⁹⁹ Thus, if an unauthorised person arranges regulated business transactions between two private individuals the transaction is valid, but if he arranges a transaction between a private individual and a regulated firm, the transaction may be voided by the private person but not the regulated firm.¹⁰⁰

1.5 Territorial scope of the regulatory regime

The territorial scope of the FSMA 2000 is considerably greater than the territorial scope of the legislation which preceded it in that it seeks to cover not only business done into the UK with UK investors but also business done from the UK with non-UK investors. The latter case necessarily gives rise to conflicting regulation of the particular transactions concerned, but in practical terms it is clear that the regulator best placed to control business is the regulator in whose territory the business

⁹⁷ Section 29. Interestingly, a person who has made an illegal deposit is not entitled to compensation for loss sustained and is therefore in a weaker position under the FSMA 2000 than he was under the Banking Act 1987.

⁹⁸ Section 27(4).

⁹⁹ Section 27.

¹⁰⁰ Section 27(1)(b). Section 28 permits the courts to order that the transaction be enforced if the regulated firm actually knew that the intermediary was conducting regulated business in breach of Section 19. There is no clear explanation as to why the test here (knowledge) is different from the test applied in direct transactions ("reasonable belief").

is controlled.¹⁰¹ Since the primary motivation of securities regulation is the protection of consumers, it follows that it is legitimate for securities regulators to concern themselves with sales by persons operating in their jurisdiction to consumers in other jurisdictions.

Section 19 relates to the performance of regulated activities “in the United Kingdom”. This term is to be interpreted in accordance with its ordinary meaning. However, Section 418 extends the meaning of the term “in the UK” to cover five cases which do not fall within that ordinary meaning.

- (a) Case 1: where a person who has his registered office¹⁰² in the UK conducts regulated business in any other EEA Member State under a single-market passport, that business is subject to the FSMA 2000. This is an interesting provision. Its basis is presumably the provision of the Investment Services Directive¹⁰³ to the effect that “Each Member State shall make access to the business of investment firms subject to authorisation for investment firms of which it is the home Member State”.¹⁰⁴ There is clearly no basis for interpreting this as applying only to the business of investment firms as conducted within the national boundaries of the Member State concerned, and if such a limitation cannot be implied then the ordinary meaning of the term must be that it refers to investment business done anywhere within the EU. Consequently, Case 1 can be said to give effect to the UK’s EU obligations, although this wide approach to directive implementation is not believed to have been adopted in other EEA countries. The potential problem which this scope provision creates is that where a firm which is authorised and has its head office in one Member State conducts investment business in another, the implementation and supervision of compliance with applicable rules of conduct shall be the responsibility of the Member State in which the service is provided.¹⁰⁵ However, the point presumably is that the rules which are imposed upon such a

¹⁰¹ The instance which is always given in this context is the problems which the UK had in the early 1980s from “boiler room” operations based in the Netherlands telephone selling securities to retail investors in the UK.

¹⁰² Or, if he does not have a registered office, his head office. It should be remembered that the Investment Services Directive prohibits firms incorporated in one Member State from having their head office in a different Member State.

¹⁰³ 93/22/EEC.

¹⁰⁴ Defined as the Member State in which the firm has its registered office.

¹⁰⁵ Investment Services Directive, Article 11.

firm are imposed by its home authority, and it is therefore necessary for the home regulator to have authority over such offshore business in order to be able to impose such restrictions in the first place.

- (b) Case 2: this closely parallels Case 1, but it applies where the person concerned is exercising rights conferred under the Undertakings for Collective Investment in Securities ("UCITS")¹⁰⁶ rather than the Investment Services Directive.
- (c) Case 3: this covers situations in which a UK-incorporated¹⁰⁷ company provides investment services anywhere in the world and the day-to-day management of the carrying out of that activity is the responsibility of an establishment maintained by that person in the UK. Given the uncertainty as to the meaning of the term "establishment", it is entirely arguable that visiting managing directors making phone calls whilst they change planes at Heathrow could be engaging in the management of a business from an establishment in the UK, depending upon whether their physical presence here is sufficient to constitute an "establishment".

The most helpful authority in interpreting this requirement is the decision in *Re Oriel Ltd*,¹⁰⁸ in which the Court of Appeal considered the meaning of the term "established place of business". Oliver LJ said:

"when the word 'established' is used adjectivally ... it connotes not only the setting up of a place of business at a specific location, but a degree of permanence or recognisability as a location of the company's business. If, for instance, agents of an overseas company conduct business from time to time by meeting clients or potential customers in the public rooms of an hotel in London, they have, no doubt, 'carried on business' in England but I would for my part find it very difficult to persuade myself that the hotel lounge was an 'established place of business'. The concept, as it seems to me, is of some more or less permanent location not necessarily

¹⁰⁶ Council Directive on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities 85/611/EEC.

¹⁰⁷ Or established. The formulation "if it does not have a registered office, its head office" is a difficult one in the context of UK legal persons, as it is hard to see how a legal person could have its head office in the UK without also having a registered office there.

¹⁰⁸ [1986] 1 WLR 180.

owned or leased by the company but at least associated with the company and from which habitually or with some degree of regularity business is conducted.”

This appears to be a sufficiently clear finding to be a usable basis for the analysis of this clause. Applied in the context of non-UK investment business, it leads to the conclusion that a business will be the subject of day-to-day management from an establishment in the UK if the individuals responsible for the management of that business spend some time in London, at tolerably regular intervals, and have business facilities available for their use in London on a systematic basis. In real terms, if the head of the Japanese securities business has a desk maintained for his use in London, comes over, say, four times a year, and makes work-related phone calls whilst in London, the Japanese securities business will be within this case.

- (d) Case 4: this covers non-UK companies whose head offices are outside the UK which maintain places of business in the UK and conduct investment business from them. This case is distinct from Case 3 in that in Case 3 the requirement is that the activity be managed from an establishment in the UK, whereas in Case 4 the requirement is that the activity be conducted from an establishment in the UK. This will catch UK branches.
- (e) Case 5: this covers information society services. An information society service is defined¹⁰⁹ as a service normally provided for remuneration, at a distance, by electronic means and at the individual request of a recipient of services. The principles which apply to information society services are that they should be regulated in the country where they are provided and not in the country where they are delivered. Thus, an information society provider established in the UK should (in theory) be subject to UK regulation in respect of all of his EEA business, and should be exempt from regulation in every other EEA jurisdiction.

This is implemented in the UK through Case 5, which provides that where a UK person provides an information society service elsewhere in the EEA he will be subject to UK regulation. The mirroring provisions exempting EEA information society service providers from regulation in the UK are found dotted throughout the RAO.¹¹⁰

¹⁰⁹ In Article 2(a) of the E-Commerce Directive, 2000/31/EC.

¹¹⁰ Articles 9AA (deposits), 12A (insurance), 51A (collective investment schemes) and 72A (securities and derivatives transactions).

This particular piece of dot-com froth has had an uncertain meaning ever since its enactment, and the extreme difficulty that has been encountered in interpreting it has ensured that in practice the information society services regime has remained unused.

1.5.1 Inward regulation

The regulation of activities conducted by overseas persons into the UK has always been a matter of some difficulty. Dual regulation is generally regarded as undesirable and likely to be self-defeating in terms of effective supervision. Furthermore, where UK customers elect to deal with overseas firms, it is assumed that they do so on the basis of overseas regulation, and that they should neither expect nor be entitled to UK regulatory protections.

This policy is implemented through Article 72 of the RAO. This provides that where an overseas person enters into a transaction with a UK person, there are two broad sets of circumstances in which the transaction is unregulated in the UK. These are:

- (a) where the transaction is entered into with an authorised person in the UK,¹¹¹ or is entered into through an authorised person, or is entered into as a result of an arrangement made with an authorised person; and
- (b) where the transaction is entered into, either directly or indirectly, with any person in the UK and the transaction is the result of either an unsolicited approach by the UK person or a solicitation made by the overseas person which does not contravene the financial promotion restriction.¹¹²

There is a particular issue with territoriality as regards deposits. It has always been a difficult exercise to establish where a deposit is accepted. The principal issue here is that the common law reverses the ordinary

¹¹¹ Or an exempt person acting in the course of a business comprising a regulated activity in respect of which he is exempt.

¹¹² UK regulated firms are prohibited from approving advertisements for the benefit of overseas persons unless they are satisfied that the overseas firm will deal with UK customers in an "honest and reliable way" (COB 3.12.6(2)). As no one knows what this means or how it might be established, in practice overseas firms are restricted to soliciting business in circumstances where the Financial Promotion Order exempts the relevant promotion from the financial promotion regime.

rule of English contract law as to payments in respect of deposit contracts. The ordinary rule in England is that the debtor is obliged to seek out his creditor and tender the amount due; consequently as a general rule the situs of a debt is the ordinary place of business of the creditor. However, for a bank, the bank's promise to repay is to repay at the branch where the account is kept.¹¹³ Thus the situs of a deposit is generally taken to be the situs of the bank branch at which the deposit is made.¹¹⁴ Where a deposit is made through the ordinary international payment systems, the point where the transfer is actually made to the recipient is (ultimately) the place where the clearing system in respect of that currency is located – thus, all US dollar deposits are made in New York, all sterling deposits are made in London. There are thus four ways in which a deposit can be said to be accepted in the UK:

- (a) that it is paid to an EU office of a UK entity operating under a passport (under Case 1 above);
- (b) it is paid to any office of a UK entity controlled from the UK;
- (c) that it is paid to the UK establishment of a non-UK entity (under Case 4 above); and
- (d) that it is paid in sterling, regardless of the place of establishment or the place of business of the recipient.

1.6 The European dimension

The Treaty of Rome is the nearest thing that the EU currently has to a constitution. Article 52 of the Treaty prohibits the imposition of any restriction on the freedom of establishment of a national of one Member State in the territory of another Member State, and entitles any national of a Member State to be established in the territory of another Member State “under the conditions laid down for its own nationals by the law of the country where such establishment is effected”. In a corporate context, “establishment” means either the incorporation of a subsidiary

¹¹³ *Joachimson v Swiss Bank Corpn* [1921] 3 KB 110 at p. 127; see also *Woodland v Fear* (1857) 7 E & B 519; *Prince v Oriental Bank Corpn* (1878) 3 App Cas 325 (PC); *R v Lovitt* [1912] AC 212; *Garnett v McKewan* (1872) LR 8 Exch 10.

¹¹⁴ There is a fascinating issue which arises in the context of non-banks, that being whether the bank rule as to the place whereby a deposit is accepted still applies, or whether the contractual rule applies. The regulatory approach to this issue seems to be to assume that the entity concerned is a bank and to seek to identify at which “branch” of the entity the deposit would be taken to be accepted.

in another Member State¹¹⁵ or the doing of some activity through a branch or agency which is physically located in the other Member State. Article 52 has direct effect within the community,¹¹⁶ and a person from one Member State who is not permitted to establish himself in another on the same terms as nationals of that other may obtain relief directly from the European Court of Justice or through the courts of the state concerned.

Article 59 of the Treaty complements Article 52 by providing that any person who is a national of a Member State shall not suffer any restriction in respect of his freedom to provide services to nationals of other Member States. "Services" in this context is limited to services which are normally provided for remuneration,¹¹⁷ and financial services usually fall within this category. By definition cross-border services are provided without the establishment of permanent place of business in the Member State concerned, but Article 60 provides that where the provision of services involves a temporary presence in the target Member State the provider of the services should be permitted to pursue his activity "under the same conditions as are imposed by the state on its own nationals". The freedom to provide services has frequently been found irksome by those governments with strong beliefs in the importance of regulation, and attempts are regularly made to restrict the provision of services in one way or another, usually by subjecting the providers of such services to further regulation based upon claims that such regulation is required in the name of the "general good". The European Court of Justice considered such restrictions in 1986 in *Commission v France*,¹¹⁸ and held that such restrictions might be imposed only where they were:

"justified by the general good and . . . applied to all persons or undertakings operating within the territory of the state in which the service is provided in so far as that interest is not safeguarded by

¹¹⁵ Curiously companies, unlike individuals, may not change their state of establishment as a company is a creature of a specific legal system (case 81/87 *R v HM Treasury and Commissioners of Inland Revenue ex parte Daily Mail and General Trust PLC* [1988] ECR 5483).

¹¹⁶ Case 2/74 *Reyners v Belgian State* [1974] ECR 631.

¹¹⁷ Article 60 of the treaty, and see Case 352/85 *Bond van Adverteerders v Netherlands* [1988] ECR 5365.

¹¹⁸ Case 220/83 [1986] ECR 3663.

the provisions to which the provider of a service is subject in the Member State of his establishment.”¹¹⁹

Thus the principle of home state control and minimum necessary interference in the provision of services is embedded in the jurisprudence of the ECJ and of the Treaty. It has also been developed by the court. Thus Article 59 of the Treaty has been held to prohibit requirements that a national of a Member State who provides services in another must create a permanent establishment in that state.¹²⁰ Perhaps more importantly, the court has been prepared to consider restrictions alleged to be imposed for the general good on a case-by-case basis, and, in particular, has held¹²¹ that such provisions may be invoked only in the context of retail provision of services, and cannot be invoked in respect of services provided to commercial undertakings having no need of specific protection.

Since Article 59 has also been held to have direct effect¹²² it would appear that the requirements for the creation of a single European market in financial services were all in place by the mid 1980s by virtue of the then-existing decisions of the ECJ. Of course, the reality was very different. Financial services are always a sensitive area for governments, and in particular the dominant position of London as the capital of European financial activity gave rise to concerns in most continental European governments that financial liberalisation within the community would simply accelerate the trend amongst their own domestic financial institutions to relocate progressively more of their undertakings to London. Consequently, Member States continued to impose the greatest possible burdens on institutions based in other states, and it was clear that without further action on the part of the Commission the idea of a single European market in financial services would remain a dead letter.

¹¹⁹ At page 3708. This may be considered as an application of the general principles laid down in the *Cassis de Dijon* case (Case 120/78 *Rewe-Zentral v Bundesmonopolverwaltung für Branntwein* [1979] ECR 649). Although the *Cassis de Dijon* principle itself applies only to the sale of goods, it has been held to be applicable in the case of the supply of services (Case 262/81 *Cotitel SA v Ciné-Vog films SA* [1982] ECR 3381).

¹²⁰ Case 33/74, *Van Binsbergen v Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid* [1974] ECR 1299; Case 205/84, *Commission v Germany* [1986] ECR 3755.

¹²¹ Case 205/84, *Commission v Germany* [1986] ECR 3755.

¹²² Case 33/74 *Van Binsbergen v Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid* [1974] ECR 1299.

The Commission revived progress towards the single European market generally with its white paper published in 1985 entitled "Completing the Internal Market", which famously set the date of 1992 as its target for this completion. In the context of financial services, it was clear that in order to make progress two issues needed to be addressed. One was the extent to which a national of a Member State providing services into another Member State should be subject to the supervision of both regulators. Clearly both had a part to play, but the aim was to allocate responsibilities such that what resulted was a single composite supervisory regime rather than the imposition of two complete, unconnected and possibly conflicting national regimes. The other was to spike the guns of those states which wished to continue to use "the general good" as a means of trade protection by establishing universally accepted standards of regulation; the idea being that once a government of a particular Member State had recognised that companies supervised in other Member States were subject to adequate regulation it could no longer justify the imposition of further regulation on a "general good" basis.¹²³

The solutions which were found to these two issues were interconnected. The division of responsibility between competing supervisory authorities turned out to be the easier to deal with, and responsibilities were allocated so that the home state regulator continued to supervise the structure and management of the firm concerned, whilst the host state supervisor supervised its compliance with rules relating to individual transactions and the conduct of business generally. Thus every Member State could be allowed to retain its own marketing rules, for example, but would be forced to recognise that other regulators were capable of verifying capital adequacy and management structures.

This solution fell a very long way short of the ideal of complete freedom of provision of services across national boundaries, but it did constitute a workable compromise and was adopted enthusiastically across the whole range of financial services regulation. Thus the same basic structure of home/host state responsibilities coupled with the establishment of basic common criteria for authorisation is to be found across all

¹²³ There is a tendency in this area to assume that all attempts by host governments to impose further regulations on the basis of the "general good" are nothing more than disguised trade protection. However, there is a respectable case to be made for some of these regulations based on principles of consumer protection and fairness – see the Economic and Social Committee's opinion on the draft Second Banking Co-ordination Directive (OJ 1988 C318/42) for a strong restatement of the value of such provisions.

the relevant directives,¹²⁴ and it is this which provides the current passport regime.

It will thus be seen that the passport regime, which currently forms the basis for the regulation of cross-border services into and out of the UK, is in fact a compromise which has been created to form a basis for the development of the fundamental freedoms which are in fact guaranteed by the treaty itself.

However, this structure does leave the UK with an issue. If the only activities which are regulated are those covered by the single-market directives then both treaty and single-market obligations will be satisfied. However if, as in the UK, Parliament chooses to regulate activities which are not within the scope of the single-market directives, then as regards those activities the UK would be in breach of its obligations under the Treaty if it simply mandated EEA firms to obtain UK authorisation in order to conduct those activities in the UK.

As a result of this the FSMA 2000 provides two¹²⁵ routes for EEA firms to operate in the UK. One is the passport regime in relation to the various directives which is established by Schedule 3. The other is the Treaty Rights regime which is established by Schedule 4.

1.6.1 The single European passport regime

Schedule 3 to the FSMA 2000 provides an integrated procedure for dealing with “passport” applications. Paragraph 12 of the schedule provides that an EEA firm which is in possession of a passport and which satisfies either the “establishment conditions” or the “service conditions” is automatically entitled to be authorised. The establishment conditions, which must be satisfied by a firm wishing to establish a branch in the UK, are that the firm has received a notice from its home regulator which consents to the firm’s establishment of a branch in the UK and specifies the activities which the home regulator consents to being carried out through the branch. The FSA is also empowered to prescribe that further

¹²⁴ Second Banking Co-ordination Directive (89/646); Investment Services Directive (93/22/EEC) and Capital Adequacy Directive (93/6/EEC), the Third Life Assurance Directive (92/96/EEC) and the Third Non-life Insurance Directive (92/49/EEC).

¹²⁵ Strictly three, since Schedule 5 also creates automatic authorisations. However, this schedule is somewhat specific and deals only with an inconsistency in the passport regime as between the ISD and the UCITS directives.

information be provided by the home regulator and to refuse the application from the firm if the regulator does not provide such information. The FSA has two months in which to notify the firm concerned of the legal requirements with which it will be expected to comply. The "service conditions", which must be satisfied by a firm wishing to provide cross-border services into the UK, differ very slightly in that in the case of credit institutions and Investment Services Directive ("ISD") firms. The firm is only required to give notice to its home regulator which may give "negative clearance", and consequently no formal communication between the home regulator and the FSA is required. Upon the conditions set out in paragraphs 13 and 14 being satisfied, the firm concerned is not only automatically authorised but also¹²⁶ receives automatic permission to carry out the activities specified in the consent notice given by its regulator (or, where no such notice is required, in the notice given by the firm concerned to its home regulator specifying the investment activities in which it intends to engage).

Part III of Schedule 3 provides for the equivalent procedure to be followed by a UK firm which wishes either to set up a permanent establishment or to provide services into a Member State. It lays down the conditions which must be satisfied in terms of the notifications that must be provided to the FSA and the required contents thereof.

1.6.2 The Treaty Rights regime

Schedule 4 applies to EU firms¹²⁷ which are authorised to do some sort of regulated activity in their home state and which wish to provide services or seek to establish a branch in the UK, but whose activities are not covered by any of the directives. The schedule is therefore to some extent a catch-all, and its insertion has clearly been necessitated by a desire to retain the greatest possible freedom to designate activities as "regulated activities" without having to be constrained by the scope rules of the directives.

A firm which wishes to exercise its rights to freedom of establishment or to provide services in such a case is entitled to automatic authorisation in two sets of circumstances. One of these is that the home state concerned has complied with "a community instrument for the co-ordination or

¹²⁶ Para. 15.

¹²⁷ Note that because this schedule gives effect to rights which accrue under the Treaty of Rome it does not apply to nationals of EEA countries which are not signatories to that treaty.

approximation of laws, regulations or administrative provisions of Member States relating to the carrying on of" the activity concerned, and the other is that the Treasury has certified that the relevant provisions of the law of the firm's home state afford equivalent protection to that which is afforded by or under the FSMA 2000 to customers of UK firms. The mechanical provisions of this schedule are slightly different from those set out in Schedule 3 – for example the notice period before business can be commenced is reduced to seven days¹²⁸ – but the aim is clearly to replicate the bare bones of Schedule 3 without inserting extra restrictions which might subsequently be subject to a challenge as being contrary to the treaty.

¹²⁸ Para. 5.

