resolved by the Supreme Court by looking to that EU legislation for a statement of the purposes underpinning those regulations and their consequent substantive law analysis.[4] This indicates that even in relation to questions about English private law, the principles identified in EU law may be decisive in the final analysis.

2–02 The policy underpinning EC securities regulation is the upshot of the development of a single market for securities across the EU so that companies and other issuers will be able to access a much wider and deeper market for capital than is possible in ordinary debt markets. That is, people in continental European jurisdictions had commonly used ordinary lending to fund their business activities; whereas the securities markets in the US and in the UK had meant that there was a different source of funding for businesses by means of shares, bonds and so forth. The allure of securities to expand the markets for capital in the EU led to the development of securities regulation policy which is discussed in this chapter. It became the accepted wisdom that to achieve a viable, single securities market, the EU must go some way towards "harmonising" or, as has been accepted more recently, "approximating" the regulatory treatment of securities issues and trading across its territory within each Member State. Whereas the EC Securities Directives (as considered below) have tended to withdraw their objectives onto the more limited and achievable terrain of the mere "approximation" of laws relating to the offer of securities to the public, the Markets in Financial Instruments Directive ("MiFID", considered below) is bolder in its attempt to encourage competition between the service providers which provide markets in various forms of security by permitting regulatory authorisations given in one jurisdiction to be relied upon across the EU more generally. The marketing of securities and their admission to listing are governed by the Securities Directives. The publication of prospectuses in an approved form and compliance with continuing obligations seek to ensure the availability of sufficient and adequate information for the investing public. To prevent the abuse of information and its concomitant effect on market integrity, Directives on insider dealing (leading to its criminalisation in the UK), market abuse and market manipulation have also been implemented so as to enhance investor confidence in these securities markets. Each of these legislative developments is considered in this chapter, as a preface in the remainder of this book to the manner in which those principles are enshrined in UK securities law and regulation. Also in this chapter are discussions of some underpinning principles of EU law to which these Financial Services Directives relate. First, however, a short account of the development of EC securities regulation, so that the present

[4] That litigation related to the collapse of Lehman Brothers and the claims of that bank's clients to be entitled to proprietary rights in moneys which should have been segregated to their account under the Client Asset Sourcebook (but which had not been because Lehman Brothers was in the practice of ignoring its regulatory obligations in this regard): those regulations implemented provisions of the Markets in Financial Instruments Directive which was found by the Supreme Court to be aimed at the protection of customers' interests, which in turn founded an analysis that the assets held in a general fund by Lehman Brothers should be deemed to have been held on trust for all of the bank's customers in proportions drawn from their contractual entitlements against the bank: *Re Lehman Brothers International (Europe) (in administration) v CRC Credit Fund Ltd* [2012] UKSC 6; [2012] Bus. L.R. 667; Hudson, *The Law and Regulation of Finance* (2013), para 9–91 *et seq.*

norms on which securities law is predicated can be better understood. The de Larosière Report,[5] which is discussed in detail below,[6] constituted the official response of the EU to the financial crisis which began in the summer of 2007 and reached its nadir in the autumn of 2008. Even before the Eurozone crisis began to bite deeply, the Larosière Report made several far-reaching proposals for the reform of financial regulation policy across the EU. Thus far, those proposals have not reached the securities regulation area; although the proposal that in the future there should be a "single rulebook" for financial regulation across the EU will mean a break with the existing practice of using Directives to create securities regulations, in favour of directly applicable Regulations. The shape of policy in this regard is considered below.

THE GENESIS OF EC LEGISLATION ON FINANCIAL SERVICES

The birth and formative years of EC financial services law

2–03 This section considers the development of financial services regulation in the EU. What follows is an examination of some of the core principles of EU law which are applicable to financial services, before an examination of EC securities regulation in particular in the latter half of the chapter.

The failure, thus far, to create a single market for securities

2–04 Hitherto the EU has failed to form a viable, pan-European market in securities. The implementation of MiFID in November 2007 may lead to a greater inter-penetration of domestic securities markets, and the Prospectus Directive and the Transparency Obligations Directive (discussed below) have both had an impact too: but nevertheless, thus far, the EU has failed to create a single, all-embracing securities market across the EU. Instead, Member States have continued to administer their domestic securities markets in substantively different ways. Indeed, the implementation of the EC Securities Directives in the UK through the *FCA Handbook* permits the "gold-plating" of the European requirements with the more stringent regulatory requirements usually applied in the London securities markets. This process of gold-plating—prohibited in the main in the context of the MiFID—raises the issue, considered below, as to how effecting subtly different domestic regulation in the UK tallies with the harmonising objectives of the EU legislation.[7] This picture becomes more

http://www.pbookshop.com

[5] Report of the High Level Group on Financial Supervision in the EU, February 25, 2009: *http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf* [Accessed September 12, 2013]

[6] See para.2–13.

[7] See Moloney, "New Frontiers in EC Capital Markets Law: from market construction to market regulation" (2003) 40 *Common Market Law Review* 809; Avgouleas, "The new EC financial markets legislation and the emerging regime for capital markets" (2004) 23 Y.E.L. 321; Avgouleas, "The harmonisation of rules of conduct in EC financial markets: economic analysis, subsidiarity and investor protection" (2000) 6 E.L.J. 72; Wymeersch, "The EU directives on financial disclosure" (1996) 3 E.F.S.L. 34; Slot, "Harmonisation" (1996) 21 E.L. Rev. 378; Weatherill, "After *Keck*, some thoughts on how to clarify the clarification" (1996) 33 *Common Market Law Review* 885, 903.

complicated when we consider that the more recent EC Directives on listing securities have not been implemented in the UK by FCA regulation but rather have been implemented by including high-level principles in principal legislation—either the Financial Services and Markets Act 2000 ("FSMA 2000") or the Companies Act 2006 ("CA 2006")—which are then supplemented by subordinate legislation and FCA regulation. The potential conflict is therefore no longer simply between EC Directives and FCA regulation, but is rather a potential conflict now between EC legislation and UK legislation.

2–05 For the future, the likely outcome of these conflicts between the different legislative codes is that the EU will introduce directly applicable "Regulations" instead of the directly effective "Directives" where the Directives permit the Member States to implement the regulations as they see fit with an obligation only to ensure that a bare minimum is reached, whereas the use of Regulations will mean that the precise terms of the EU legislation will be directly applicable in the Member States without any room for manipulation or gold-plating. The goal, as a result of the Larosiere Report, is the creation of a "single rulebook" for the EU as a whole, instead of allowing Member States great freedom in the precise framing of their municipal regulations. This likely future change is considered in detail below.

The relationship of free movement of capital with securities markets

2–06 It was the 1957 Treaty of Rome which created the principle of free movement of capital within the European Economic Community. The original approach to financial services in the European Economic Community was predicated solely on the idea of free movement of capital; however, that principle was not in itself sufficient to spark the creation of an effective single market in financial services. The 1966 Segré Report[8] highlighted shortcomings in the provision of financial services and in the regulation of securities markets across the Community typified by the different regulatory regimes dealing with securities markets and the provision of investment services between Member States. It was the Segré Report which advocated the harmonisation of national laws dealing with financial services. However, no advances towards this goal were made in the next 10 years. In 1977 the Commission recommended a European Code of Conduct relating to Transferable Securities[9] but this also failed to jump-start the development of a viable, pan-European securities market; although it did provide a central reference point for regulators in considering the manner in which securities were issued in their jurisdictions. The problem remained that securities markets were regulated differently in different Member States, that a security admitted to trading in one jurisdiction would not necessarily qualify to be traded in another jurisdiction, and so forth.

[8] Report by a Group of Experts Appointed by the EEC Commission, *The Development of a European Capital Market* (1966).

[9] Recommendation 77/534 [1977] OJ L212/37.

From harmony to difference

2–07 The original policy objective, first enunciated in the Segré Report, was to provide for the harmonisation of securities regulation across the Community: that is, to make the various municipal systems of securities regulation effectively the same. It is suggested that the distinct systems of substantive law in each jurisdiction would have made it impossible to have securities law made identical in each Member State in any event. For example, the substantive English law of contract is fundamentally different from the French law of contract within the French civil code, and therefore the detail of the whole of securities law could not be harmonised without profound alterations to national substantive laws. Consequently, the efforts at harmonisation have only focused on the equivalence of securities *regulations* as effected by the competent regulatory authority of each Member State.

2–08 Whereas the early changes to securities regulation concentrated on harmonisation, latterly policy initiatives have focused on two objectives. First, the creation of common minimum standards which each Member State must incorporate into their national laws. The important ramification of this dilution of the harmonisation agenda is that each Member State has been able to "gold-plate" its own securities regulations by imposing stricter regulations than are required by the minimum statutory standards, provided that all participants in that state's securities market are held to the same standards. There is therefore only an *approximation* of the minimum standards across the EU in the securities regulation field, as opposed to a *harmonisation* of those regulations. Harmonisation would require that all became identical; whereas approximation recognises that there has been a substantial movement towards the similarity of the regulations in each jurisdiction, even though there remain significant differences in some contexts. Secondly, rather than harmonise municipal laws, any issue of securities which is approved in one Member State is deemed to have approval permitting the issue of those securities across the EU. The metaphor used to describe this process is that of creating a "passport" for an issue of securities such that an issue of securities may travel around the EU provided that it has been authorised by its home Member State. The "passport" regime is considered next.

Passporting

2–09 The well-known *Cassis de Dijon* decision,[10] as transposed to the context of securities regulation, established a principle that (*mutatis mutandis*) if an instrument were acceptable in one Member State then it ought to be considered to be acceptable in another. This principle became very significant in the financial services field because it developed the policy objectives of Community law in relation to securities issues onwards from simply wishing for a single market for securities with harmonisation of the regulations of each Member State into the idea that there should be "passport" to all securities markets in the Community

[10] *Rewe-Zentral AG v Bundesmonopolverwaltung fur Branntwien (Cassis de Dijon)* (120/78) [1979] E.C.R. 649.

http://www.pbookshop.com

for any financial instrument once it had been authorised by the competent authority in the issuer's home state. Passporting remains an important part of MiFID in relation to regulatory approvals: such that approval in one Member State is applicable in all other Member States.

The emergence of the Lamfalussy methodology

2–10 The beginnings of a serious legislative movement towards the modernisation of securities regulations in the Community can be identified in the Investment Services Directive of 1993[11] ("ISD", which has since been superseded by MiFID). Nevertheless, it required the Financial Services Action Plan ("FCAP") of 1999[12] to reinvigorate the legislative agenda. The principal concern was that the lethargy in the production of adequate, harmonised securities regulation across the EC was due in the part to the slowness with which Directives were produced compared to the pace of change in the securities markets themselves. Market practice since the passage of the ISD in 1993 has seen an explosion in the electronic trading of securities, great developments in trading platforms operated off-exchange, the growth of over-the-counter derivatives and securitisation products, and a large number of securities-related corporate governance scandals. Consequently, the markets changed rapidly very soon after the implementation of the ISD.[13] Hence the need for FCAP to refocus attention on the harmonisation of securities markets, of which more below.

2–11 In the wake of the FCAP, the so-called "Committee of Wise Men", chaired by Baron Alexandre Lamfalussy, produced its final report in February 2001 (generally known as "the Lamfalussy Report")[14] which, inter alia, suggested a new methodology for the creation of EC Directives in the securities field. The Lamfalussy process is at the heart of modern securities regulation in the EU, and therefore continues to be important in the future analysis of those regulations. This methodology was comprised of four levels of legislation: framework principles, implementing measures, co-operation and enforcement. The first level identifies framework principles which are to be provided in the Securities Directives and the second level leaves it to the Commission to create regulations dealing with more technical issues. This division in competence means that the principal legislation in the form of directives needed only to establish underlying principles without the need to deal with the technical detail which might otherwise delay the legislative process. Directives could therefore be enacted much more quickly than previously with the result that they could respond more quickly to changing market practice. Consequently, the regulation of those markets is predicated on broad principles which are better able to adapted and applied to rapidly changing markets than the old style of directive which was comprised of more detailed rules which were susceptible to going out of date more quickly. The third level of legislation encapsulates guidance from the

[11] Directive 93/22 [1993] OJ L141/27.
[12] COM (1999) 232.
[13] This Directive has now been displaced by the Markets in Financial Instruments Directive ("MiFID") as implemented in November 2007.
[14] Named after the Baron Lamfalussy who chaired this committee.

http://www.pbookshop.com

Committee of European Securities Regulators ("CESR") which seeks to ensure uniform implementation of the framework principles and the technical material by the competent authorities of each Member State. CESR is a committee comprised of central bankers who are able to talk to market conditions at any given time and therefore to guide the policy of the EU more accurately. The fourth level is an enforcement mechanism via the Commission.

2–12 As a result the Lamfalussy process has generated a structure which can be both reactive to change in securities markets, and yet also provide for detailed regulation and the review of those detailed regulations. The impact, for example, on FCA regulation has been, as is considered in the next chapter, a change in the drafting style of the FCA Handbook in that technical regulations are usually copied into the rulebooks as opposed to being paraphrased in the FCA's own regulatory concepts. This, it is suggested, will constitute an important trend in the approximation of securities regulation across the EU if replicated in other Member States. The policy underlying the EU's approach to securities market regulation before the Larosière Report was based on two assumptions. First, a perception that the securities markets in the EU were too fragmented. Secondly, a determination embodied in the Financial Services Action Plan that the different norms across the EU required harmonisation. As a result the Directives governing the admission of securities to listing on stock exchanges within the EU were introduced. In turn the Securities Directives have the following principal policy objectives. First, the creation of efficient markets so that companies are able to access liquid capital by means of issuing securities and so that there are securities markets available to investors. Secondly, to ensure investor protection in these securities markets. This second policy has not been dealt with as well by European legislation at present in relation, for example, to conduct of business regulation: consequently, it has frequently been a matter for regulation by the competent authorities of Member States. However, the implementation of MiFID promises to prompt seismic changes in conduct of business regulation across the EU, even in jurisdictions such as the UK in which conduct of business regulation had previously been rigorously provided for in FCA regulation.[15]

The de Larosière Report

The analysis propounded by the Larosière Report

2–13 The effects of the financial crisis of 2007–2009 on the EU have been twofold. First, the effect on the solvency of the banks trading in the EU and the seizure in its financial systems. Secondly, the Eurozone crisis which has seen Member States like Ireland, Portugal, Greece and Cyprus require bail-outs, as well as much larger Member States like Spain and Italy being pressed into serious financial difficulties.[16] The effect of both of these linked crises has been to force the EU to change its policy on the method by which it conducts financial

[15] See para.3–38.
[16] For an account of the financial crisis generally, see Hudson, *The Law and Regulation of Finance* (2013), Ch.57.

frankness and co-operation between national regulators,[30] and no means for supervisors to make common decisions.[31] Again, these shortcomings are significant in relation to the perceived failure of the EU to establish cross-border regulation within the EU area. The upshot of these observations was the recommendation for an entirely new regulatory structure within the EU. That new structure is considered next.

The new regulatory structure

2–16 To meet the need for reinforced systemic regulation, the Report advocated the creation of the European Systemic Risk Board ("ESRB").[32] To draw the national regulators together, a functional differentiation was created between the securities regulators, the insurance regulators, and the banking regulators: these colleges of regulators would deal with micro-prudential regulation.[33] It is a principle of micro-prudential regulation that government must be kept out of this sort of supervision so that political priorities do not interfere with the objective business of overseeing individual firms.

2–17 The new EU regulatory structure is divided up functionally. Therefore, there are regulators to deal with macro-prudential regulation, micro-prudential regulation, and specific conduct of business regulation. Macro-prudential regulation is concerned with the regulation of the entire financial system and with protecting that system against systemic risk.[34] Micro-prudential regulation is then concerned with the solvency and condition of individual financial institutions (whether banks, investment houses, insurance companies, pension funds and so forth). This form of regulation considers each financial institution separately but is not necessarily concerned with over-arching macro-prudential questions. The third tier of regulation relates to the way in which financial institutions deal with their customers ("conduct of business" regulation, discussed in Ch.7), and market products to their customers, and behave in the market generally (i.e. avoiding criminal activity such as market abuse and insider dealing (Ch.26)). The new EU regulatory architecture looks like this, in four tiers:

ESRB

European Systemic Risk Board—responsible for *macro*-prudential regulation, i.e. the protection of the entire EU financial system from systemic risks.

ESFS

[30] Larosière Report, para.159.
[31] Larosière Report, para.162.
[32] Larosière Report, para.177.
[33] Larosière Report, para.183.
[34] See Hudson, *The Law and Regulation of Finance* (2013), para.1–47.

European System of Financial Supervisors—responsible for *micro*-prudential regulation, i.e. the solvency and condition of individual, regulated financial institutions (such as banks and investment houses) across the EU. The ESFS in turn draws together the following sectoral bodies (i.e. bodies which are responsible for specific financial markets):

EBA

European Banking Authority;[35]

EIOPA

European Insurance and Occupational Pensions Authority;

ESMA

European Securities and Markets Authority

National supervisory authorities

The competent regulatory authorities of individual Member States mirroring the EU bodies, such as the Bank of England's subsidiary entities in the UK: the Financial Policy Committee (macro-prudential); the Prudential Regulatory Authority (micro-prudential); and the Financial Conduct Authority (conduct of business, etc.). The UK entities are discussed in Ch.3.

http://www.pbookshop.com

The competent regulatory authorities of individual Member States mirroring the EU bodies, such as the Bank of England's subsidiary entities in the UK: the Financial Policy Committee (macro-prudential); the Prudential Regulatory Authority (micro-prudential); and the Financial Conduct Authority (conduct of business, etc.). The UK entities are discussed in the following chapter.Thus macro-prudential oversight is maintained at the top of this diagram by the ESRB looking across the entire financial system and not being caught up in the minutiae of individual firms. However, many financial crises are, of course, precipitated by the failure of sensitively placed individual firms. Nevertheless, micro-prudential regulation is collected into the ESFS which draws together the three sectoral regulators—which are responsible for the significant financial market sectors of banking, insurance and pensions, and securities and related markets generally—which in turn draw together the national supervisory authorities which are the competent authorities in each Member State of the EU for each of these functions (macro-prudential, micro-prudential and other regulation) and each of these market sectors. Of course, the national supervisory authorities will often be involved both in the micro-prudential regulation of individual institutions within their jurisdictions and in the macro-prudential regulation of financial markets in their jurisdictions.

[35] There is also the European System of Central Banks.

however, the pursuit of those common law or equitable claims is not precluded by the Act. Under the terms of the statute itself, the amount of compensation may be an amount agreed between the parties[69] or an amount determined by the court;[70] although it is suggested that the statute remains opaque as to those items which the court or the parties are required to take into account or to ignore in relation to the calculation of such compensation thus throwing the parties back onto the general law. Any agreement entered into by an unauthorised person is unenforceable on similar terms.[71]

The regulation of "regulated activities" under the FSMA 2000

The definition of "regulated activity"

3–29 As considered immediately above, a person must be authorised by the FCA if that person is to carry on a regulated activity. It is important, therefore, to define the meaning of the term "regulated activity". The statutory definition of a "regulated activity" given in s.22 of the FSMA 2000 is as follows:[72]

> "(1) An activity is a regulated activity for the purposes of [FSMA 2000] if it is an activity of a specified kind which is carried on by way of business and—
> (a) relates to an investment of a specified kind; or
> (b) in the case of an activity of a kind which is also specified for the purposes of this paragraph, is carried on in relation to property of any kind.
> (2) Schedule 2 makes provision supplementing this section.
> (3) Nothing in Schedule 2 limits the powers conferred by subsection (1).
> (4) 'nvestment' includes any asset, right or interest.
> (5) 'Specified' means specified in an order may by the Treasury."

Therefore, there are two key elements to this definition: the activity must be carried on by way of business and it must relate to a specified form of investment. Each of these elements is considered in turn below.

3–30 The seven categories of regulated activity which are identified in Sch.2 to the FSMA 2000 are:[73] dealing in investments, arranging deals in investments, deposit taking, safekeeping and administration of assets, managing investments, investment advice, establishing collective investment schemes, and using computer-based systems for giving investment instructions. The categories of "investment" provided in Sch.2 are:[74] securities, instruments creating or acknowledging indebtedness, government and public securities, instruments giving entitlement to investments, certificates representing securities, units in collective investment schemes, options, futures, contracts for differences, contracts of insurance, participation in Lloyd's syndicates, deposits, loans secured on land, and rights in investments.

[69] Financial Services and Markets Act 2000 s.28(2)(a).
[70] Financial Services and Markets Act 2000 s.28(2)(b).
[71] Financial Services and Markets Act 2000 s.27(1).
[72] Financial Services and Markets Act 2000 s.22(1).
[73] Financial Services and Markets Act 2000 Sch.2 paras 2–9.
[74] Financial Services and Markets Act 2000 Sch.2 paras 10–24.

http://www.pbookshop.com

The significance of identifying a regulated activity

3–31 It is important to know whether or not an activity is a regulated activity within the RAO because any person conducting a business in relation to any of those activities will require authorisation to do so from the FCA, as set out above. Conducting a regulated activity as a business without authorisation constitutes a criminal offence,[75] unless one has taken all reasonable precautions and exercised all due diligence to avoid the commission of that offence.[76] It is also an offence to claim to be an authorised person or to hold oneself out as being an authorised person if one is not so authorised,[77] unless one has taken all reasonable precautions and exercised all due diligence to avoid the commission of this offence.[78] It is also an offence to advertise any investment business by means of "an invitation or inducement to engage in investment activity"[79] as set out under the "financial promotion" code, considered below.[80]

The meaning of "business"

3–32 As outlined above, the specified investments must be carried on by way of business to fall within the RAO. The definition of the term "business" in the law of finance is something which must be divined from those few cases which have considered this term. The meaning of "activities carried on by way of business" is defined by Treasury regulation, further to s.419 of the FSMA 2000. However, the appropriate regulation is very vague about the content of "business" for these purposes.[81] In *Morgan Grenfell & Co v Welwyn Hatfield DC*[82] Hobhouse J. suggested that there was no reason to impose a narrow meaning on the term "business" in the context of the Financial Services Act 1986 (now repealed) and that that term:

> "should not be given a technical construction but rather one which conformed to what in ordinary parlance would be described as a business transaction as opposed to something personal or casual."[83]

A similar approach has been taken in all of the case law in this context.[84]

3–33 The frequency of the investment activity might be a guide to, but not conclusive of, the question whether or not a business of investment is being carried on.[85] While many of the decided cases on the meaning of the term "business" have emphasised the frequency with which the activity must be carried on to constitute

[75] Financial Services and Markets Act 2000 s.23(1).
[76] Financial Services and Markets Act 2000 s.23(3).
[77] Financial Services and Markets Act 2000 s.24(1).
[78] Financial Services and Markets Act 2000 s.24(2).
[79] Financial Services and Markets Act 2000 s.25(1).
[80] Financial Services and Markets Act 2000 s.25(1).
[81] The Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 para.3.
[82] *Morgan Grenfell & Co v Welwyn Hatfield DC* [1995] 1 All E.R. 1.
[83] *Morgan Grenfell & Co v Welwyn Hatfield DC* [1995] 1 All E.R. 1.
[84] *American Leaf Blending Co Sdn Bhd v Director General of Inland Revenue* [1979] A.C. 676.
[85] *Morgan Grenfell & Co v Welwyn Hatfield DC* [1995] 1 All E.R. 1.

connected strictly to having "parted with" the money or other property under the agreement; however, the pursuit of those common law or equitable claims are not precluded by the Act. Under the terms of the statute itself, the amount of compensation may be an amount agreed between the parties[99] or an amount determined by the court;[100] although it is suggested that the statute remains opaque as to those items which the court or the parties are required to take into account or to ignore in relation to the calculation of such compensation thus throwing the parties back onto the general law. Any agreement entered into by an unauthorised person is unenforceable on similar terms.[101]

3–37 An unenforceable agreement resulting from an unlawful communication under s.21 of the FSMA 2000 may, however, be enforced by a court or a court may order that money or property transferred under the agreement be retained[102] provided that the court is satisfied that it would be "just and equitable" to do so.[103] The court is obliged to consider[104] whether or not the offeror realised the communication was unlawful[105] and whether or not the offeror knew that the agreement was being entered into as a result of that unlawful communication.[106]

3–38 Where the communication is made by an authorised person, then the conduct of business rules (considered immediately below) apply to the suitability of that communication.

CONDUCT OF BUSINESS REGULATION

Introduction

3–39 The Markets in Financial Instruments Directive ("MiFID")[107] replaced the Investment Services Directive[108] of 1993 in relation to the regulation of markets in financial instruments. Its implementation in the UK has been effected for the purposes of this discussion of securities markets by the Conduct of Business Sourcebook ("COBS"), which now forms part of the *FCA Handbook* and which replaced the old conduct of business sourcebook as from November 1, 2007.[109]

http://www.pbookshop.com

[99] Financial Services and Markets Act 2000 s.28(2)(a).
[100] Financial Services and Markets Act 2000 s.28(2)(b).
[101] Financial Services and Markets Act 2000 s.27(1).
[102] See *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] A.C. 669, below, where a transfer of property under a contract void *ab initio* was, nevertheless, held to have been a good transfer of title in spite of the void nature of that contract, thus requiring the claimant to seek restitution at common law or in equity.
[103] Financial Services and Markets Act 2000 s.30(4).
[104] Financial Services and Markets Act 2000 s.30(5).
[105] Financial Services and Markets Act 2000 s.30(6).
[106] Financial Services and Markets Act 2000 s.30(7).
[107] The Markets in Financial Instruments Directive ("MiFID") 2004/39.
[108] Directive93/22.
[109] It should be noted that at the time of writing COBS was only in draft form, as provided in FCA 2007/33 which had displaced FCA 2007/03 in its entirety in May 2007. That version had a number of provisions left intentionally blank. The text relies primarily on that draft but has been updated as far as

MiFID has been supplemented by the MiFID Implementing Directive ("MID")[110] and a Commission Regulation.[111] Broadly-speaking there are three areas of regulation covered by MiFID: first, the authorisation and required organisation of investment firms; secondly, the organisation and transparency of securities markets; and, thirdly, regulation of the conduct of business between investment firms and their customers.

Conduct of Business

The MiFID Conduct of Business principles

3–40 MiFID sets out principles dealing with the conduct of business in the following manner. The principles underpinning MiFID were considered in detail in Ch.2. In this chapter, while setting out the appropriate MiFID standards, the FCA COBS is considered.[112] Each of the principal obligations set out in MiFID is considered in the following sections in turn.

The requirement that investment firms act honestly, fairly and professionally

3–41 Each investment firm is required to act "honestly, fairly and professionally in accordance with the best interests of its client".[113] This rule is referred to in COBS as the "client's best interests rule". As is referred to below in relation to the "best execution principle",[114] the conduct of business principles are important because they impose positive obligations on investment firms to look to the best interests of their clients. This is more, it is suggested, than simply avoiding conflicts of interest under FCA regulation or under the general law relating to fiduciary obligations. Those obligations are, in effect, a negative obligation not to allow conflicts of interest. By contrast, conduct of business regulation imposes positive obligations on investment firms to act in their clients' best interests, which in turn requires that investment firms assess their clients' objectives so that their clients' best interests can be ascertained and achieved. Otherwise, the requirement to act honestly may be satisfied by acting in compliance with regulation and otherwise than acting dishonestly, and the requirement of acting fairly might be satisfied by avoiding acting unfairly. However, the qualification that the firm must act in accordance with the client's best interests imposes an

possible to account for the final version of those rules implemented on November 1, 2007. See also Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2007 (SI 2007/126).
[110] MiFID Implementing Directive ("MID") 2006/73.
[111] Regulation 1287/2006.
[112] It should be noted that at the time of writing the Conduct of Business Sourcebook ("COBS") was only in draft form, as provided in FCA 2007/33 which had displaced FCA 2007/03 in its entirety in May 2007. That version had a number of provisions left intentionally blank. The text relies primarily on that draft but has been updated as far as possible to account for the final version of those rules implemented on November 1, 2007.
[113] MiFID art.19(1); COBS 2.1.1R.
[114] See para.3–85.

be either an institution which satisfies two of the following standards: a balance sheet total of £20 million, net turnover of £40 million, or own funds of £2 million; or a large body corporate or limited liability partnership with called up share capital of £10 million or a large undertaking which satisfies two of the following standards: a balance sheet total of £12.5 million, net turnover of £25 million, or an average number of employees during the year of 250.[138]

3–52 A person may elect to be treated as a professional counterparty so that investment business may be done in a different fashion. Such "elective professional clients" may be treated as such if the firm has undertaken:

> "an adequate assessment of the expertise, experience and knowledge of the client that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved."[139]

It is also required that the client must ask in writing to be treated as an elective professional client, and that the client has been given a written warning by the firm of the rights and protections which they may thus lose, and the client must state in writing in another document that it is aware of the consequences of losing those rights and protections.[140] In relation to MiFID or third country business it is required that two of the following three requirements are satisfied: the client must have carried out at least 10 transactions of sufficient size per quarter over the previous 4 quarters; that the client's instrument portfolio exceeds 500,000; or that the client has worked in the financial sector for at least one year in a professional position which required knowledge of the transactions which they envisage entering into.[141] However, an elective professional client is not to be assumed to possess the knowledge and experience of a "per se professional client".[142]

3–53 The categories of eligible counterparties divide between "per se" clients and "elective" clients, as with professional clients above. A "per se eligible counterparty" will include (unless classified differently under a later classification)[143] a credit institution, an investment firm, an insurance company, a collective investment scheme, a pension fund or its management, any other EC or EEA approved financial institution in the securities or banking or insurance sectors, an exempted dealer under MiFID, a national government, a central bank, or "a supranational organisation".[144]

3–54 A client may be an elective eligible counterparty if it is a "per se professional client" or if the client requests such a categorisation in respect of transactions in relation to which it could be treated as a professional client.[145] A counterparty's confirmation that it wishes to be treated in this fashion may be obtained under a general agreement covering all future transactions or on a transaction-by-transaction basis.[146]

3–55 While clients may request to "trade up" to a higher, elective category, a firm is obliged to allow a professional client or an eligible counterparty to be re-categorised as a form of client with a higher degree of protection.[147] Alternatively, a firm may "on its own initiative" treat clients as retail clients or otherwise under a more beneficial regime from the perspective of client protection.[148] Re-categorisation may take place on a trade-by-trade basis or in relation to classes of transaction or in relation to all transactions.[149] The client must be informed of such a re-categorisation.[150]

3–56 An important issue arises in relation to re-classification, in particular in relation to an investment firm realising on its own initiative that a client should be re-classified under COBS. Significantly it is the FCA's view that it is the responsibility of a professional client to ask for the higher protections offered under COBS[151] if that client has been classified as being overly expert, and therefore the onus is not on the investment firm to re-categorise a client it considers to be less expert than the client considers.

3–57 It is a thorny question, however, whether or not an investment firm could be said to be acting with integrity if it failed to re-categorise a client when its officers realised that that client did not possess the knowledge and expertise that the parties have previously considered the client had. After all, if I do not have sufficient knowledge or expertise to judge a transaction, then how can I be said to have had the knowledge or expertise to attest that I had sufficient knowledge or expertise to accept the risks associated with a particular categorisation. A firm acting with integrity, it is suggested, should refuse to treat a client in accordance with the categorisation which the client desires if there is good reason to believe, either before or after the original categorisation, that that client does not have the appropriate level of expertise or knowledge. To do otherwise would be severely to diminish the effect of the "know your client" project which is made up of two parts, if it is to have any genuine effect at all: first, the client's evidence as to its own expertise and, secondly, the investment firm's genuine investigation and ongoing sense of whether or not that evidence gives a meaningful assessment of that client's knowledge and expertise. Investor protection regulation, such as that in COBS, requires that firms protect clients from their own naivety at this stage, even if it does not go anything like as far as requiring a firm to refrain from making a profit from a client with greater self-confidence than skill. The purpose of this regulation is to expose investors to appropriate levels of risk and that must require that the classification process is carried out in good faith.

[138] COBS 3.5.2R generally.
[139] COBS 3.5.3(1)R.
[140] COBS 3.5.3(3)R.
[141] COBS 3.5.3(2)R.
[142] COBS 3.5.7G.
[143] COBS 3.6.2(1)R.
[144] COBS 3.6.2(1)R. cf. MiFID art.24(2).
[145] COBS 3.6.4R.

[146] COBS 3.6.6R.
[147] COBS 3.7.1R.
[148] COBS 3.7.3R.
[149] COBS 3.7.7G.
[150] COBS 3.7.6G.
[151] COBS 3.7.2G.

http://www.pbookshop.com

will constitute prompt, fair and expeditious execution of client orders reference should be had to their performance "relative to other client orders or the trading interests of the investment firm".[181]

Standard of communication with customers and a comparison with case law

3–68 As considered above, COBS provides a general requirement that when the seller communicates information to a customer, it must do so in a way which is "clear, fair and not misleading".[182] This principle is an advance over the pre-FSMA 2000 (and therefore now defunct) Bank of England London Code, particularly as it affected the decision of the High Court in *Bankers Trust v Dharmala*.[183] In that case it was held by Mance J., partly in reliance on best practice established by the Bank of England London Code, that the seller was not obliged to disclose all of the risks associated with a product to the buyer given its level of expertise and also, importantly, that the seller's officers were entitled to recognise that it would make a large profit from the transaction at its client's expense without being liable for regulatory breach or for misrepresentation or fraud. Under this expanded principle of "clear, fair and not misleading" communications it is suggested that the seller would need to ensure that its marketing material and also any statements made at meetings were not capable of being misconstrued, that they were clear as to their effect, and that they were entirely "fair" with regard to the customer's own position. In this regard, the regulations provide that the seller must have regard to the level of knowledge which the buyer has of the transaction at issue when making written or oral communications.[184] Further, the seller must ensure that its officers do not take any inducements or "soft commissions" in effecting transactions.[185]

3–69 What emerges from this case is that there were no positive obligations on the seller of the derivative as to best execution nor was there evidence that the seller had conducted the sort of careful assessment of the claimant's expertise in derivatives markets as is now required under MiFID. Consequently, it is suggested, that a retail client, or an inexpert professional client who was either recognised as being inexpert by the seller or who asked to be treated as being inexpert (as permitted under s.3.7 of COBS, considered above), would be in a better position now in relation to common law or equitable claims of the sort brought in *Bankers Trust v Dharmala* because the investment firm would not be able to hide behind either the less exacting London Code nor behind a judge's finding that as a professional firm Dharmala ought to have been able to form its own assessment of the risks associated with the products in question. Rather, it is suggested, the investment firm's knowledge that their clients were inexpert, and therefore that profits could be made comparatively easily from transacting with them due to the investment firm's greater knowledge and expertise, in itself

http://www.pbookshop.com

[181] MiFID art.22(1).
[182] COBS 4.2.1R.
[183] *Bankers Trust v Dharmala* [1996] C.L.C. 481.
[184] COBS 4.8.1R *et seq.*
[185] COBS 2.3.1R.

would constitute a breach of the requirement that an investment firm act with integrity and use its power to identify a professional client as having insufficient expertise so that that client should be re-categorised under COBS 3.7.3R. However, in COBS 3.7.2G it is the responsibility of a professional client to ask for the higher protections offered under COBS. See the discussion of this issue above.[186]

Suitability in the conduct of business: suitability of method of sale and suitability of the product in itself

3–70 It is important not only that the product is suitable for its purpose, but also that the product is appropriate for the particular client[187] and also that its advice to buy a particular product is given in a suitable way.[188] The test adopted throughout MiFID and COBS, as considered above, is that the seller must have taken "reasonable steps"—the expression adopted by the case law for example in relation to the enforcement of domestic mortgages against co-habitees of the mortgagor[189]—in relation to its treatment of that client. The type of reasonable steps which will be suitable are not susceptible of general definition but rather will vary greatly, depending on the needs and priorities of the private customer, the type of investment or service being offered, and the nature of the relationship between the firm and the private customer and, in particular, whether the firm is giving a personal recommendation or acting as a discretionary investment manager. In so doing the firm is required to ensure that the product is the most suitable of that type of product for the purpose,[190] and bear in mind that further to MiFID in terms of best execution another product may be more suitable if it would be available at a lower price and would achieve the client's objectives.[191]

The obligation to give warnings as to risks

3–71 Under COBS and under art.19(5) of MiFID, an investment firm must ensure that the buyer understands the risks associated with the product[192] and give an appropriate risk warning, as considered above. This notion of sufficient risk warning was significant in *Bankers Trust v Dharmala*[193] in deciding whether or not the buyer could be taken to have understood fully all of the risks associated with the interest rate swaps involved.[194] Another interesting example of this

[186] See para.3–74 *et seq.*
[187] COBS 10.2.1R.
[188] COBS 9.2.1R. Practice in conduct of business regulation has been that, in relation to retail clients, the seller is required to keep its treatment of such customers under regular review. The polarisation rules require that the seller be giving independent advice wherever possible and that in circumstances in which it is acting otherwise than entirely in the clients interests—for example, if it is a market maker or acting as a discretionary fiduciary of some sort—then that status must be communicated adequately to the client in the context of the buyer's level of expertise.
[189] *Barclays Bank v O'Brien* [1994] A.C. 180.
[190] COBS 9.2.1R *et seq.*
[191] COBS 11.2.1R *et seq.*
[192] COBS 10.3.1R, and see also COBS 9.6 generally.
[193] *Bankers Trust v Dharmala* [1996] C.L.C. 481.
[194] See Hudson, *Financial Derivatives* (2013), para.7–09. See also para.25–14 of this book.

by an "insider". The term "insider" is defined by s.118B of the FSMA 2000 to mean "any person who has inside information" on one of the following bases:[218]

> "(a) as a result of his membership of an administrative, management or supervisory body of an issuer of qualifying investments,
> (b) as a result of his holding in the capital of an issuer of qualifying investments,
> (c) as a result of having access to the information through the exercise of his employment, profession or duties,
> (d) as a result of his criminal activities, or
> (e) which he has obtained by other means and which he knows, or could reasonably be expected to know, is inside information."

Section 119 of the FSMA 2000 required the FCA to create a Code on Market Conduct to specify with greater exactitude what sorts of behaviour would and would not constitute market abuse.[219] That Code is referred to as "MAR 1" within the *FCA Handbook* and is considered in detail in Ch.6 *Corporate governance and procedures internal to the issuer of securities*.[220] This Code requires that the instrument in question be one which is traded on an existing market and in which there is a continuing market. It is important to recognise that the types of behaviour which the Financial Services Authority intends to encompass within this regime relate not only to dealing directly in shares and other instruments but also to any behaviour which affects their value more generally.[221] Further, that behaviour may take place in another jurisdiction but nevertheless have an impact on instruments traded in the UK and so fall within the market abuse code.[222] It is likely that the FCA will consider the application of particular market practices to the derivatives markets in deciding whether or not any particular activity is an abuse of a market. Those standards will clearly be of great importance in the application of the Code, given the importance given over in that Code to close consideration of the norms usually applied in particular markets,[223] in particular when seeking to apply the "reasonable user" test outlined above.[224]

[218] Financial Services and Markets Act 2000 s.118B.
[219] Financial Services and Markets Act 2000 s.119.
[220] See para.6–05.
[221] MAR 1, 1.11.8E.
[222] MAR 1, 1.2.9G.
[223] MAR 1, 1.2.3E.
[224] Cf. *Polly Peck v Nadir* [1992] 4 All E.R. 769, where an objective test of reasonableness is used in relation to a claim for knowing receipt but where that objectivity is tempered by making reference to a "reasonable banker" in relation to financial transactions and not simply to an average person who may or may not have any banking knowledge. The standard used by the legislation of a hypothetical "reasonable user" of the market is intended to replicate the "reasonable man" test used frequently by the common law to establish a level of objectivity but while also retaining some recognition of the particular context within which that defendant is operating; thus creating a test more akin to the "average trader on the Stock Exchange" than "the man on the Clapham omnibus".

The FCA Market Tribunal

3–79 The FCA Market Tribunal ("the Tribunal") was established by s.132 of the FSMA 2000.[225] The Tribunal's rules are created in part under the Financial Services and Markets Tribunal Rules 2001 such that the Tribunal may have an oral hearing or it may give its decision without a hearing, it may call witnesses, and the applicants and respondents have the opportunity as described in the rules to make representations. Various provisions of the FSMA 2000 permit a reference to be made to the Tribunal by way of appeal from a decision of the FCA. As is considered through Pt 4 of this book in particular, the FCA will frequently make decisions as to dealings in securities, as well as exercising its general powers under the FSMA 2000 as considered in this chapter.

OVERLAPS BETWEEN FINANCIAL REGULATION AND THE GENERAL LAW

The synthesis of financial regulation and the general law

3–80 There are significant overlaps between substantive law and regulation. Principally this relates to the adoption by the English courts of concepts of financial regulation and of financial best practice in deciding whether or not a number of substantive law tests have been satisfied, such as the extent of the duty of care in negligence, whether or not institutions have acted as an honest institution would have acted in the circumstances, and whether or not institutions have dealt with particular categories of customer appropriately and so forth.[226] One example of this osmosis between regulation and substantive law—as considered in outline above—is the decision of the English High Court in *Bankers Trust v Dharmala*[227] in which Mance J. made explicit reference to the approach taken by the self-regulatory organisations towards conduct of client business as according with the requirements of substantive law.[228] It is suggested that the future for the substantive law of finance is a closer assimilation with the principles of financial regulation precisely because the requirements of financial regulation constitute an objective statement of what is expected of a regulated person in any given circumstance suitable for the disposal of many substantive law claims. Also of importance will be the obligations of individual traders and advisors to comply with regulatory requirements of integrity and, for example, to make disclosure of any information required by FCA regulation. Failure by such individuals to comply with FCA regulation will also, it is suggested, open up such

[225] SI 2001/1775.
[226] *Cowan de Groot Properties Ltd v Eagle Trust Plc* [1992] 4 All E.R. 700 at 761, per Knox J.; *Heinl v Jyske Bank (Gibraltar) Ltd* [1999] Lloyd's Rep. Bank 511 at 535, per Colman J.; *Bank of Scotland v A Ltd* [2001] 3 All E.R. 58; *Sphere Drake Insurance Ltd v Euro International* [2003] EWHC 1636 (Comm); *Manolakaki v Constantinides* [2004] EWHC 749; *Tayeb v HSBC Plc* [2004] EWHC 1529 (Comm); [2004] 4 All E.R. 1024.
[227] *Bankers Trust v Dharmala* [1996] C.L.C. 508.
[228] Hudson, *The Law and Regulation of Finance* (2013), Ch.3 on the increasing overlap between regulatory principles and substantive law particularly in circumstances in which the latter is seeking to formulate a test based on reasonable behaviour in any given market.

http://www.pbookshop.com

of any other arrangement such that the company's net assets are reduced[60] (thus implying that value has shifted from the company to some other person so as to acquire shares).

6–29 The second prohibition on financial assistance will arise if the purchaser of those shares takes on a liability in so doing and if the company then undertakes to reduce or expunge that liability: thus, indirectly passing value to the purchaser and so giving financial assistance.[61] The third prohibition on financial assistance will arise if a person is acquiring shares in a private company, it is not lawful for a public company which is a subsidiary of that private company to give direct or indirect financial assistance for that acquisition.[62] There is also a prohibition, akin to s.678(3), to the effect that it is not lawful to reduce a liability so as to facilitate the acquisition.[63]

A breach of any of the prohibitions is a criminal offence

6–30 A contravention of any of the prohibitions on the giving of financial assistance in s.678(1) or (3), or s.679(1) or (3) of the CA 2006 constitutes a criminal offence.[64]

The meaning of financial assistance as developed in the case law

The pattern in the cases

6–31 The law on financial assistance has undergone frequent changes with re-draftings of the principles in successive Companies Acts. The current exceptions are the result of successive dilutions of the original principle, inter alia, to permit assistance in relation to private companies and with the larger objective of permitting otherwise unobjectionable transactions. This section presents a short survey of the types of transaction which have been found to constitute financial assistance, observing that the judiciary has tended to tighten the effective meaning of financial assistance culminating perhaps in the decision of the House of Lords in *Brady v Brady*.[65] What emerges from the case law is that the financial assistance must be financial in nature[66] and that it must be given for the purpose of acquiring the shares.[67] We shall deal first with the categories of activity which have been treated as constituting financial assistance and then with purposes for which the assistance was given within the scope of a larger transaction. All of these cases were decided on the basis of subtly but significantly different statutory provisions predating the Companies Act 2006.

[60] Companies Act 2006 s.677(4).
[61] Companies Act 2006 s.678(3).
[62] Companies Act 2006 s.679(1).
[63] Companies Act 2006 s.679(3).
[64] Companies Act 2006 s.680(1).
[65] *Brady v Brady* [1989] A.C. 755; [1988] 2 All E.R. 617.
[66] *Barclays Bank v British and Commonwealth Holdings Plc* [1996] 1 W.L.R. 1.
[67] See generally the cases considered below, e.g. *Brady v Brady* [1989] A.C. 755; [1988] 2 All E.R. 617.

The types of activity which constitute financial assistance

6–32 Financial assistance may be given directly or indirectly. The clearest example of direct financial assistance would be an outright transfer of money to an individual who stands at arm's length from the company so that that individual becomes able to acquire a parcel of the company's shares. Another example of direct financial assistance would be a company lending money to a third party so that the third party could acquire shares, even if the parties' intention was that latterly the loan would be repaid: the company would nevertheless have assisted the acquisition of the shares by making their acquisition possible. The simplest means of taking over a company remains procuring the agreement of that company to pay for its own shares by lending the money to do so to the person who intends to take the company over. Private equity typically operates on a subtly different basis by borrowing money at arm's length and then undertaking to repay those loans, once the company has been acquired, out of the company's own assets. If the private equity purchaser had acquired the loan from the company then that would constitute financial assistance, as would a guarantee over the loan from the company, or some other means of making the loan available. It is not necessary for the company to have had its assets reduced so as to facilitate the acquisition: all that seems to be required is that the company assisted the financing.[68]

6–33 These examples of loan cases have begun to veer into indirect financial assistance. In *Belmont Finance Corporation v Williams Furniture Ltd (No.2)*[69] Buckley L.J. considered a company buying goods from a supplier and the supplier then using that money to buy shares in the company. His Lordship considered that there would not be financial assistance if the company had needed the goods which it had acquired, so that the payment of money only constituted a part of a larger transaction and was not intended solely to assist the purchase of shares. By contrast, if the company had not required the goods and had acquired them merely as a means of paying money to the supplier so that then supplier would be able to acquire the company's shares, then there would have been financial assistance. What is more difficult is to decide on cases in which there was a mixture of objectives: partly to fund the acquisition and partly to acquire goods. These "mixed motives" cases are considered in the next section.

6–34 In *Charterhouse Investment Trust Ltd v Tempest Diesels Ltd*,[70] a company, a part of a management buy-out, had sold all of the shares in a subsidiary company to one of its directors and thus sold a part of its business to that director. The issue was whether a transfer of tax losses between the two companies, when the subsidiary was hived off, would constitute financial assistance. Hoffmann J. held that the transfer of the tax losses constituted a part of a much larger transaction and therefore could not be viewed as financial assistance in isolation. Hoffmann

[68] *Belmont Finance Corp v Williams Furniture Ltd (No.2)* [1980] 1 All E.R. 393.
[69] *Belmont Finance Corp v Williams Furniture Ltd (No.2)* [1980] 1 All E.R. 393.
[70] *Charterhouse Investment Trust Ltd v Tempest Diesels Ltd* [1986] 1 B.C.L.C. 1.

http://www.pbookshop.com

CORE PRINCIPLES

One of the key components of financial regulation is control over the manner in which investment products are marketed to the general public. It is an offence under s.21 of the Financial Services and Markets Act 2000 ("FSMA 2000") to market regulated products to any person without authorisation from the Financial Conduct Authority ("FCA"). There are a number of statutory exceptions to this offence. Of particular concern are the activities of "boiler rooms" which pressure members of the public into investing in (often) inappropriate products. Financial promotion regulation is thus aimed at investor protection.

INTRODUCTION

The scope of the financial promotion code

7–01 The Financial Services and Markets Act 2000 ("FSMA 2000") and the *Financial Conduct Authority Handbook* together establish a code on the regulation of "financial promotion": that is regulatory control over the way in which regulated financial institutions advertise and promote their services and products to their pre-existing customers and others. The Financial Conduct Authority ("FCA") assumed the responsibilities of (by assuming the name of) the old Financial Services Authority in this regard on April 1, 2013 further to s.6 of the Financial Services Act 2012. The FCA rulebook was a carbon copy at the outset of the previous rulebook. That financial promotion code displaced the previous code relating to unsolicited calls and investment advertisements in the Financial Services Act 1986.[1] The financial promotion code provides that no person shall "in the course of business, communicate an invitation or inducement to engage in investment activity".[2] This general prohibition is then hedged in with exceptions where the communication is made by an authorised person or is an authorised communication. Further exceptions are provided by means of Treasury regulation.

The practice of marketing securities

7–02 It is common practice in making an offer of shares, most particularly during a takeover, for the offeror to wish to communicate directly with shareholders, often by means of an organised telephone campaign. A well-organised telephone campaign at the right time can sway undecided shareholders to accept an offer. The same principles as to financial promotion apply equally to the regime governing investment advertisements which was previously provided for in s.57 of the Financial Services Act 1986. It is an offence to communicate an invitation or inducement to engage in investment activity by means of an advertisement in

http://www.pbookshop.com

[1] Financial Services Act 1986 s.56.
[2] Financial Services and Markets Act 2000 s.21(1).

the course of business[3] and any agreement made as a result of such an advertisement will be unenforceable, except where that is done in compliance with the financial promotion code.[4]

7–03 The FSMA 2000 financial promotion code displaces the previous code relating to unsolicited calls and investment advertisements in the Financial Services Act 1986,[5] acting principally through its central principle that no person shall "in the course of business, communicate an invitation or inducement to engage in investment activity".[6] The ambit of this general prohibition is reduced by reference to a number of exceptions where the communication is made by an authorised person or is itself an authorised communication. If an authorised person makes an authorised communication then the financial promotion code will not apply and instead the activities of that authorised person are regulated by the FCA Conduct of Business regulations governing suitable behaviour in marketing securities.[7] For an unauthorised person, breach of this central prohibition on financial promotion constitutes an offence;[8] although it is a defence to the offence for the accused to show that the defendant took "all reasonable precautions and exercised all due diligence to avoid committing the offence".[9] That the contravention of such provisions is an offence is in itself a departure from the code under the old Financial Services Act 1986.

7–04 An unenforceable agreement resulting from an unlawful communication under s.21 of the FSMA 2000 may, however, be enforced by a court or a court may order that money or property transferred under the agreement be retained[10] provided that the court is satisfied that it would be "just and equitable" to do so.[11] The court is obliged to consider[12] whether or not the offeror realised the communication was unlawful[13] and whether or not the offeror knew that the agreement was being entered into as a result of that unlawful communication.[14]

[3] Financial Services and Markets Act 2000 s.21(1).
[4] Financial Services and Markets Act 2000 s.26(1) or s.27(1).
[5] Financial Services Act 1986 s.56 (now repealed).
[6] Financial Services and Markets Act 2000 s.21(1).
[7] See para.3–60.
[8] Financial Services and Markets Act 2000 s.23(1).
[9] Financial Services and Markets Act 2000 s.23(3).
[10] Cf. *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] A.C. 669, below, where a transfer of property under a contract void *ab initio* was nevertheless held to have been a good transfer of title in spite of the void nature of that contract, thus requiring the claimant to seek restitution either at common law or in equity: A.S. Hudson, *Swaps, Restitution and Trusts* (Sweet & Maxwell, 1999) generally.
[11] Financial Services and Markets Act 2000 s.30(4).
[12] Financial Services and Markets Act 2000 s.30(5).
[13] Financial Services and Markets Act 2000 s.30(6).
[14] Financial Services and Markets Act 2000 s.30(7).

communications, an investment firm is required to act "honestly, fairly and professionally in accordance with the best interests of its clients".[35] The first obligation relates to the provision of information and requires that:

> "All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading."[36]

Therefore, the key requirement is that any communication be "fair, clear and not misleading". This principle, in itself, does not require that clients are wrapped in cotton wool in relation to securities transactions—rather, it seems to operate in parallel with the notion elsewhere in securities law that the client must be given all the necessary information in a manner which enables them to form an informed judgment as to the desirability of any given investment opportunity. This chimes in with the second obligation which requires, inter alia, that an investment firm must provide appropriate information in a comprehensible form about its services.[37]

7–17 The principle which deals with the need to acquaint clients with the risks associated with their activities comes later in this second principle which requires that an investment firm must provide a client information giving "appropriate guidance on and warnings of the risks associated with investments in" the proposed "instruments or in respect of particular investment strategies".[38] The means by which one acquaints clients with the risks associated with their proposed investments is, first, by deciding what level of expertise that client has. Thus, the third principle requires that:

> "[w]hen providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives"

so that that investment firm is able to provide suitable advice about suitable products.[39] Consequently, MiFID requires that national regulations require investment firms to identify this sort of information "so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client".[40]

[35] Markets in Financial Instruments Directive ("MiFID") art.19(1).
[36] MiFID art.19(2).
[37] MiFID art.19(3).
[38] Also of great significance is the provision of information as to all costs and charges which may arise in relation to the parties' business.
[39] MiFID art.19(4).
[40] MiFID art.19(5).

FCA Financial Promotion Rules

7–18 The FCA financial promotion rules are a subset of the Conduct of Business Sourcebook. Therefore, a discussion of financial promotion in this context is a discussion of conduct of business. The preceding discussion of MiFID forms the basis for the FCA rules which implement that Directive.

7–19 The FCA rules divide between real-time communications on the one hand—which include telephone calls, face-to-face meetings and any other real-time interaction (perhaps such as communication in a chat-room environment on-line); and on the other hand non-real-time communications which take place otherwise—this would include correspondence by letter and possibly correspondence by e-mail if it did not include such a rapid exchange of correspondence so as to become in fact a real-time conversation online.[41] The heart of the FCA rules can be summarised in the following key principles. An authorised firm must be able to demonstrate that any real-time communication is fair, clear and not misleading. By contrast a non-real-time communication must contain a fair and adequate description of the proposed investment, including an appropriate explanation of the risks involved. Where an authorised firm makes a non-real-time communication then it must certify that that communication complies with the financial promotion rules within the conduct of business sourcebook.

FCA conduct of business principles

7–20 Conduct of business regulation by the FCA is discussed in detail in Ch.3.[42] Those principles are set out in the Conduct of Business Sourcebook ("COBS").

Communications with clients generally under COBS

7–21 Communications with clients must be conducted in accordance with the financial promotions rules in Ch.4 of COBS. These communications must comply with art.19(2) of MiFID in that those communications must be "fair, clear and not misleading".[43] In so doing the firm must take into account the information which is to be conveyed and the purposes for which it is being conveyed.[44] Financial promotions in this regard must explain any risk to a client's capital, must give a balanced impression of the short- and long-term prospects for an investment's yield, must give sufficient information in relation to complex charging structures for a product from which the firm earns some commission or benefit, must name the FCA as regulator, and must give an appropriate impression of packaged or stakeholder products.[45]

[41] Conduct of Business Sourcebook ("COBS") art.7.
[42] See para.3–62.
[43] COBS 4.2.1R.
[44] COBS 4.2.2G.
[45] COBS 4.2.4G.

http://www.pbookshop.com

7–22 Statements as to past, simulated past, and future performance are dealt with in section 4.6 of COBS. Information as to past performance of relevant investments must: include information from the previous five years, it must give the source and reference period of the information, it must state clearly that past performance is no promise of future performance, it must state clearly the currency involved, and if gross figures are used then the effect of any fees, commissions or other charges must be disclosed.[46] The communication must be made in a proportionate and appropriate manner given the purpose of the communication.[47] Information about simulated past performance must: relate to an investment or financial index, it must be based on the actual past performance of one or more investment or financial indices which are the same as the investment concerned in the communication, and it must contain a prominent warning that figures based on simulated past performance are no reliable indication of future performance.[48]

7–23 A firm must not make cold calls.[49] The exceptions to this restriction are threefold.[50] First, where the recipient of the cold call and the firm have an established existing client relationship which envisages the receipt of cold calls. Secondly, where the cold call relates to a generally marketable package product which is not a higher volatility product nor a life policy. Thirdly, the cold call relates to a controlled activity to be carried on by an authorised person. Cold calls and any non-written communication must make clear the purpose of the communication, the firm making the communication, and the call must be made at an appropriate time of day.[51]

Communications specifically with retail customers

7–24 When communicating with retail clients, information must: include the firm's name, must not emphasise the benefits of relevant investments without also giving a "fair and prominent indication of any relevant risks", must be sufficient to be understood by a member of the group at whom it was directed, and must be presented in a way so as to be similarly understood.[52] Any comparisons made with other products or other firms must be meaningful and presented in a fair and balanced way.[53]

[46] COBS 4.6.2R.
[47] COBS 4.6.3G.
[48] COBS 4.6.6R.
[49] COBS 4.8.2R.
[50] COBS 4.8.2R.
[51] COBS 4.8.3R.
[52] COBS 4.5.2R.
[53] COBS 4.5.6(1)R.

EXEMPTIONS FROM THE FINANCIAL PROMOTION CODE

Introduction

7–25 The scope of the financial promotion code is defined in large part by means of the exemptions from the otherwise broad restriction contained in s.21(1) of the FSMA 2000. Those exemptions are to be found in powers exercised under s.21(5) and (6) of the FSMA 2000, and thus in the Financial Promotion Order 2005.[54] The relevant provisions of each are considered in turn.

The power to create exemptions contained in section 21 of the FSMA 2000

7–26 The power to create exemptions is contained in s.21(5) of the FSMA 2000 in the following terms:

> "(5) The Treasury may by order specify circumstances (which may include compliance with financial promotion rules) in which subsection (1) does not apply."

Thus the financial promotion restriction can be abrogated by regulation. The form of such regulation is described by s.21(6) of the FSMA 2000 in the following terms:

> "(6) An order under subsection (5) may, in particular, provide that subsection (1) does not apply in relation to communications—
> (a) of a specified description;
> (b) originating in a specified country or territory outside the United Kingdom;
> (c) originating in a country or territory which falls within a specified description of country or territory outside the United Kingdom; or
> (d) originating outside the United Kingdom."

The terms of those Treasury regulations are considered in the next section.

The Financial Promotion Order 2005

The scope of the Financial Promotion Order 2005

7–27 The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005[55] ("the Financial Promotion Order") contains the regulations setting out the exempt communications, beyond the key exemption in s.21(2) of the FSMA 2000. The Financial Promotion Order sets out the exempt categories of

[54] Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (SI 2005/1529), as amended by Financial Services and Markets Act 2000 (Financial Promotion) (Amendment) Order 2005 (SI 2005/3392), which in turn had repealed and amended Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 (SI 2001/1335).
[55] SI 2005/1529, replacing the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 (SI 2001/1335); and as amended by Financial Services and Markets Act 2000 (Financial Promotion) (Amendment) Order 2005 (SI 2005/3392).

http://www.pbookshop.com

comply with either of these requirements is "actionable" on behalf of any person who suffers loss as a result that contravention either under s.90 of the FSMA 2000 (as discussed in Ch.23) or under the general law (in the manner discussed in Ch.24).[39] Each of these provisions within s.85 is considered in turn in the paragraphs to follow.

Offers of transferable securities require the publication of an approved prospectus: Section 85(1) of the FSMA 2000

The first head of liability under section 85 of the FSMA 2000

9–21 There are two criminal offences and one head of private law liability for breach of statutory duty created in the context of offers of transferable securities to the public by s.85 of the FSMA 2000. The first offence deals with the making of offers to the public without a prospectus relating to that offer having been approved first. Further to s.85(1) of the FSMA 2000:

> "It is unlawful for transferable securities to which this subsection applies to be offered to the public in the United Kingdom unless an approved prospectus has been made available to the public before the offer is made."

Thus, a prospectus must be approved and "made available" to the public before transferable securities are offered to that public.[40] Making a prospectus available involves publishing that prospectus, suggested by the common etymological root of the words "public" and "publish". Consequently this discussion will refer to an obligation to "publish" a prospectus.

The meaning of "transferable securities" in section 85(1) of the FSMA 2000

9–22 Section 85(1) of the FSMA 2000 applies to all "transferable securities".[41] The term "transferable securities" in this context[42] "means anything which is a transferable security for the purposes of the investment services directive,[43] other than money-market instruments for the purposes of that directive which have a maturity of less than 12 months".[44] However, Sch.11A to the FSMA 2000 provides for a variety of categories of excluded instruments which would

[39] Financial Services and Markets Act 2000 s.85(4).

[40] A prospectus is published by its insertion into a newspaper circulated in the state in the EEA in which the offer is to be made, by making it available free of charge at the offices at which the securities are admitted to trading, by making it available on the company's website, or by making it available on the website of the regulated market on which the securities are to be traded: Prospectus Rules 3.2. Publication must take place within six working days before the end of the offer: Prospectus Rules 3.2.3R.

[41] Financial Services and Markets Act 2000 s.85(5).

[42] Financial Services and Markets Act 2000 s.102A(1), referring to all provisions in Pt VI of that Act.

[43] This Directive is due to be replaced by the Markets in Financial Instruments Directive ("MiFID") in the UK with effect from November 1, 2007.

[44] Financial Services and Markets Act 2000 s.102A(3).

otherwise be transferable securities which are excluded from the ambit of "transferable securities" for the purposes of s.85(1) of the FSMA 2000,[45] as considered in the next section.

The sense in which matters are "unlawful" under section 85(1) of the FSMA 2000

9–23 The term "unlawful" in s.85(1) of the FSMA 2000 can be understood as meaning that a criminal offence is committed, as considered above.[46] Further, it also means that a private law liability is created in relation to anyone who suffers loss as a result of a breach of that provision, as considered further below.[47] An offer of transferable securities can only be made lawfully—and so enforceably—to the public if a prospectus has been made available to the public, and only if that prospectus has been approved by the competent authority of the home State of its issue.[48]

Exclusions from the ambit of "transferable securities" in the Prospectus Rules

9–24 Schedule 11A to the FSMA 2000 provides for three categories of securities which are excluded from the ambit of the term "transferable securities" for the purposes of the offence committed under s.85(1) of the FSMA 2000.[49] The Prospectus Rules may also exclude categories of security,[50] but this discussion focuses on the statutory exclusions. The first category deals primarily with government and similar securities. Thus, the term "transferable securities" in the context of the prospectus rules does not refer to: units in a collective investment scheme; non-equity, transferable securities issued by the government or local authorities in an EEA state, or by the European Central Bank, or the central bank of an EEA state; shares in the share capital of the central bank of an EEA state; and transferable securities which are irrevocably and unconditionally guaranteed by the government or a local or regional authority of an EEA State.[51] Also excluded from the definition of "transferable securities" in this context are non-equity transferable securities which are "issued in a continuous or repeated manner by a

[45] There was previously a set of exempt securities contained in Sch.11 to the Financial Services and Markets Act 2000, which also contained a gloss on the definition of an "offer to the public" as a result. However, Sch.11 was repealed by the Prospectus Regulations 2005 (SI 2005/1433) reg.2(1), Sch.1 para.16 as from July 1, 2005. It is now Sch.11A which contains the set of exempt securities, as introduced by the Prospectus Regulations (SI 2005/1433) reg.2(2) Sch.2 as from July 1, 2005.

[46] See para.12–21.

[47] See para.23–01.

[48] Financial Services and Markets Act 2000 s.85(7).

[49] There was previously a set of exempt securities contained in Sch.11 to the Financial Services and Markets Act 2000, which also contained a gloss on the definition of an "offer to the public" as a result. However, Sch.11 was repealed by the Prospectus Regulations 2005 (SI 2005/1433) reg.2(1) Sch.1 para.16 as from July 1, 2005. It is now Sch.11A which contains the set of exempt securities, as introduced by the Prospectus Regulations (SI 2005/1433) reg.2(2) Sch.2 as from July 1, 2005.

[50] Financial Services and Markets Act 2000 s.85(5)(b).

[51] Financial Services and Markets Act 2000 s.85(5)(a), as supplied by Financial Services and Markets Act 2000 Sch.11A.

http://www.pbookshop.com

required by the legislation, although in practice that is likely to be the case in relation to such a small issue. It would ordinarily be the case that such an issue would be one targeted at a group of expert investors identified by the issuer's professional advisors. This is true not least because such a small pool of targeted investors would need to buy a large number of securities to make such a small-scale marketing drive worthwhile. Therefore, the targeted investors would need to be expert in ordinary circumstances. Self-evidently, while an offer to 99 ordinary members of the public would be within the literal terms of the exemption, it would not be the sort of activity anticipated by the legislation. Moreover, if a marketing campaign were arranged such that ordinary members of the people were approached in groups of 99 people at a time in an effort to avoid the prospectus rules, then that would not appear to be within the spirit of the regulations and might be held to contravene the core principle that a regulated person must act with integrity.

Large issues

9–36 Thirdly, there is no contravention of s.85 of the FSMA 2000 in relation to offers of a sufficient size that they are beyond the reach of small investors, specifically if, as provided in s.86(1):

> "(c) the minimum consideration which may be paid by any person for transferable securities acquired by him pursuant to the offer is at least 100,000 euros (or an equivalent amount)."[81]

Again the underlying purpose of the legislation is not contravened if the issue is of a size which will ordinarily put it beyond the reach of inexpert investors and the general investment public whom the regulations are intended to protect. The effect of issuing securities for a large value in this manner would mean that the offer would not be one which would be made to the *public* but rather only in effect to a limited range of investors. As such it is not the sort of issue which is the principal focus of the prospectus rules, all other things being equal.

Large denomination issues

9–37 Fourthly, there is no contravention of s.85 in relation to large denominations of securities which it would be expected are also beyond the reach of small investors, specifically if:

> "(d) the transferable securities being offered are denominated in amounts of at least 50,000 euros (or equivalent amounts)."

As before, if the securities are denominated in such a large amount, then it would not be expected that they would be acquired by the sort of inexpert investor whom the regulations are intended to protect. There would, in effect, be no real *public* offer made if large denomination securities would ultimately be distributed among a comparatively narrow range of investors.

[81] Inserted by the Prospectus Regulations 2012 (SI 2012/1538).

Issues of small amounts

9–38 Fifthly, there is no contravention of s.85 if:

> "(e) the total consideration for the transferable securities being offered cannot exceed 100,000 euros (or an equivalent amount)."

For the purposes of this exemption, a series of offers made within a 12-month period relating to the same securities is treated as being a single offer.[82] As before this is not the sort of public offer of securities at which the regulations are directed.

Qualified investor acting as agent

9–39 There is a sixth potential exemption provided elsewhere in s.86 of the FSMA 2000, relating to the situation in which a non-qualified investor engages a qualified investor to act as his agent and where that agent has discretion as to his investment decisions.[83] In this circumstance, the expertise of the qualified investor will shield the issuer from liability to comply with the prospectus requirement in s.85 of the FSMA 2000. In effect this is similar to the exemption of offers to qualified investors from the scope of the prospectus rules.

http://www.pbookshop.com

Exemptions of repeat and other offers under section 86(1A) of the FSMA 2000

9–40 The term "offer" in the context of s.86 is qualified in the following way by s.86(1A) of the FSMA 2000[84] to the effect that the requirement of a "current offer" will fall within s.86(1A) "where transferable securities are resold or placed through a financial intermediary" in circumstances in which they had either previously been the subject of an offer to the public,[85] or where any of the s.86(1) exemptions applied to that offer,[86] or "a prospectus is available for the securities which has been approved by a competent authority no earlier than 12 months before the date the current offer is made",[87] or where "the issuer or the person who was responsible for drawing up the prospectus has given written consent to the use of the prospectus for the purposes of the current offer".[88] Thus, in essence, offers will be exempt if they are further offers of securities already in issue and already covered by a suitable form of prospectus, or which fall within the exempt categories in any event. The purpose of this provision is to prevent the need for replicating prospectuses where the mischief of the requirement for a prospectus is already satisfied in these limited contexts.

[82] Financial Services and Markets Act 2000 s.86(4).
[83] Financial Services and Markets Act 2000 s.86(2).
[84] Inserted by the Prospectus Regulations 2012 (SI 2012/1538).
[85] Financial Services and Markets Act 2000 s.86(1A)(a).
[86] Financial Services and Markets Act 2000 s.86(1A)(b).
[87] Financial Services and Markets Act 2000 s.86(1A)(c).
[88] This provision was added to the Financial Services and Markets Act 2000 by the Prospectus Regulations 2013 (SI 2013/1125).

regulations should stand as an objective statement of the level of compliance of regulated persons in regulated circumstances for the purposes of deciding whether or not a duty of care exists.

23–35 The key focus of securities regulation at the time of writing is in the public availability of information. As a result, where securities regulations—principally the prospectus rules—apply, then the issuers and people responsible for that prospectus know that that prospectus will be published. Indeed, its publication is a requirement of s.85 of the FSMA 2000 whether securities are to be offered to the public or admitted to trading on a regulated market. Therefore, those "people responsible" for the prospectus know that any potential investor—whether a subscriber, or a placee, or a purchaser in the after-market—will consult and rely on the statements made in that prospectus. Consequently, all potential investors must be within the issuer's contemplation when the prospectus is prepared.[63]

That duties should be owed to investors in the after-market under section 90

23–36 Let us take a moment to consider the detail of the various statutory provisions in effect in 1986 and now at the time of writing. There is only one difference of any note between the wording of s.90 of the FSMA 2000 and the wording of s.166 of the Financial Services Act 1986. The significant difference between s.90(1) of the FSMA 2000 and s.166 of the Financial Services Act 1986 is that s.90(1)(b)(ii) of the FSMA 2000 provides a right to compensation if loss has been suffered either because of an untrue or misleading statement (as in s.166) or alternatively by means of the omission of something required to be included further to the general duty of disclosure in s.87A of the FSMA 2000. This is significant because s.87A of the FSMA 2000 requires the prospectus to include any information which a reasonable investor or his professional advisors would reasonably expect to find there. Therefore, the prospectus must cater for the reasonable investor. The question then is whether this notion of the "reasonable investor" is to be limited to, for example, a group of intended placees, or alternatively is to apply generally to all potential investors in the after-market. If it can be limited by the context of the issue, then Lightman J.'s analysis could hold good; whereas if the effect of the prospectus rules (including the Listing Principles and the Prospectus Rules) is to require a prospectus suitable for all possible investors, then it is suggested that the general investing public must be considered to be within the contemplation of the people responsible for that prospectus. If the latter analysis applies then the people responsible for the prospectus must owe a duty of care to that general investing public and not simply to any limited category of investors. In relation to

[63] Another argument could proceed as follows. Investors will expect that there has been compliance with the appropriate regulations. Thus, if there had been a failure to comply with the regulations, to deny liability to any investor would essentially be to seek to excuse liability resulting from a failure to discharge one's obligations under securities regulations. However, this argument still does not answer the question why a person outwith the contemplation of the person responsible should acquire a right of action against that person responsible under s.90 or under tort law: just because I commit a wrong in relation to my dealings with X, that does not mean that Y necessarily has a right to sue me for my breach.

limited issues, the prospectus or listing particulars would need to make it clear that no person beyond the class of intended investors should rely on it. If transferable securities are being offered to the public or are to be traded on a regulated market then they are subject to exemptions from the need to publish a prospectus under the Prospectus Rules[64] and s.85(5)(b) of the FSMA 2000, in which case it is reasonable to assume that such a exempt offer of securities can be screened off from owing duties to investors in the after-market. This case is considered in greater detail in the next chapter.[65]

THE TYPES OF MISSTATEMENTS WHICH MAY GIVE RISE TO LIABILITY UNDER SECTION 90 BY REFERENCE TO DECIDED CASES IN THE GENERAL LAW

The scope of this discussion

23–37 The effect of these cases on the case law is considered in greater detail in the following chapter. This section is intended only to consider the various forms of statements made in prospectuses which would found liability under the general law, and how those case law principles might inform an analysis of s.90 of the FSMA 2000.

Misleading statements: Formally correct statements giving a misleading impression

23–38 Section 90 provides a right to compensation in relation to misleading statements in a prospectus. The question then arises as to what is meant by the term "misleading" in this context. An intentionally incorrect statement would be fraudulent, as would a statement where its maker was reckless as to the truth of its contents.[66] That much is straightforward if the prospectus effectively states that night is day or that day is night. It may be more difficult to demonstrate that representations of nuance or opinion as to the existence of facts—such as statements as to expected market conditions or customer perceptions of the issuer's manufactured goods—were false, as opposed to being unproven by subsequent events. Nevertheless, it is possible that such statements may be misleading. Thus, on the cases, a statement in a prospectus will be deemed to be untrue if it is misleading in the form it is made and in the context in which it is included. So, if representations as to anticipated market conditions make inappropriate comparisons with other companies or which use statistically inappropriate historical data, then they may not be proven to be false but nevertheless they may have the effect of misleading investors. So, in *R. v Kyslant*[67] all of the statements which had been made in a prospectus were literally true but the prospectus nevertheless failed to disclose that the dividend stated in

[64] Prospectus Rules 1.2.2R.
[65] See para.24–48.
[66] *Derry v Peek* (1889) 14 App. Cas. 337.
[67] *R. v Kyslant* [1932] 1 K.B. 442; see para.27–14.

http://www.pbookshop.com

the registration of prospectuses was to ensure that there was some written record of the terms of the investment contract entered into between the investor and the company. This history was considered in detail in Ch.4.

24–10 This section, however, considers the legacy created by the common law principles which were developed by the nineteenth century courts to deal with investments in securities. What is evident about these principles is that they require scrupulous accuracy in the preparation of prospectuses because the prospectus was the only document on which the investor could rely when deciding whether or not to invest in an undertaking. When giving judgment in *Henderson v Lacon*[18] it was Page-Wood V.C. who described these principles as being a "golden legacy". Opinion has varied as to whether or not these principles seemed to constitute a "counsel of perfection" which sits uncomfortably with modern market practice or whether they rise in tandem with a need to protect the vital British investor basis from fraud or from being more innocently misled or ill-advised.[19]

The broadened scope of liability in the twenty-first century

24–11 These "golden legacy" cases must now be approached with due regard to the state of the law and to methods and practices for the issue of securities current at the time. The common law in this area has undergone great change with the enactment of the Misrepresentation Act 1967 and also the development of the common law by the decision in *Hedley Byrne & Co Ltd v Heller & Partners Ltd*[20] and the cases following it. In consequence, the range of causes of action available to a person who has acted in reliance upon misstatements in a prospectus is much wider now than then it was. Furthermore, of course, the growth of formal securities regulation across the European Union—as considered in detail here in Ch.2—has both imposed a detailed code of obligations on the issuers of securities and developed in the context of a cross-border market in those securities.[21] Interestingly, while it might be thought that the golden legacy presented an overly stringent code for preparing prospectuses, it is nothing compared to the formalism of modern securities regulation.[22]

24–12 Furthermore, the range of possible defendants is much wider than in the nineteenth century, since a prospectus today is usually the product of the work not only of the promoters and the prospective directors of the issuing company but also of the issuing house, stockbrokers, solicitors, accountants, and auditors, and perhaps other professional persons such as engineers and valuers giving expert

[18] *Henderson v Lacon* (1867) L.R. 5 Eq. 249 at 262.

[19] See, for example, the various editions of *Palmer's Company Law*. Alfred Topham K.C., writing the 15th edn of *Palmer's Company Law*in 1933, did not suggest that he saw anything extraordinary in the consolidating Companies Act of 1929 which was enacted in the context of the (by then) well-established case law predicated on the development of the golden legacy. Some editors in the late twentieth century were more sceptical. Perhaps the clearest doubts cast on the golden legacy emerge from the discussion of the dissenting case law in the text below.

[20] *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] A.C. 465.

[21] Although, interestingly of course investment in the entrepreneurial activities of British Empire were cross-border too, although not quite in the same formalised way as the EU.

[22] See para.12–01 *et seq.*

opinions on aspects of the company's undertakings, engaged by the company. The "credit list" to a modern prospectus bears witness to this. Moreover, the requirements of the EC Securities Directives and of the FSMA 2000 (spawning the *FCA Handbook*)[23] are now of particular significance if the securities issued are to be admitted to the Official List[24] or to dealings on the Alternative Investment Market.[25] Accordingly, in considering a present day prospectus, while due regard must be given to the older authorities specifically relating to misstatements in a prospectus, regard also must be given to present day methods and practices for the issue of securities and especially to more recent authorities relating to misstatements in other contexts,[26] and not least to the web of securities regulation which imposes positive obligations on market participants. As a result, much of the case law considered in this chapter will relate to modern securities market practices[27] and perhaps signals a break with the golden legacy.

PERSONS RESPONSIBLE FOR THE PREPARATION OF THE PROSPECTUS

24–13 The principles detailing who will be responsible for the prospectus were considered in detail in Ch.21, and reference should be made to that chapter for those heads of liability created in the FSMA 2000.

http://www.pbookshop.com

LIABILITY FOR A FALSE PROSPECTUS AT COMMON LAW

24–14 Liability for a false prospectus at common law will arise in a number of different contexts, as considered in this chapter. The first question is whether or not the persons responsible for the contents of the prospectus acted fraudulently. If so, liability for damages for fraudulent misrepresentation in contract law may arise.[28] Alternatively, liability may lie for damages in tort for deceit.[29] If dishonesty was involved, then criminal liability may lie for theft or for fraud in the ways considered in Ch.27.[30]

24–15 If there was no fraud, then liability may lie for damages in contract for negligent misrepresentation: primarily under the doctrine set out in the leading case of *Caparo v Dickman*[31] and the head of liability established in *Hedley Byrne v Heller*.[32] A range of other remedies may also lie in equity: primarily the remedy of rescission to unpick the sale of securities.[33]

[23] As considered in detail in para.2–83 *et seq.*

[24] See para.11–01 *et seq.*

[25] See para.19–01 *et seq.*

[26] See para.24–31 below.

[27] See Ch.5 *Securities markets in the UK.*

[28] See para.24–105.

[29] See para.24–19.

[30] See paras 27–14 and 27–19.

[31] See para.24–32.

[32] See para.24–34.

[33] See para24–139.

24–16 Depending upon the context, the seller of the securities may have been acting in a fiduciary capacity in providing investments or investment advice to the buyer,[34] in which case liability will lie in constructive trust for any secret profit or conflict of interest;[35] or liability may lie for breach of trust.[36] Any individual who gave investment advice, even if working for a financial institution, may be personally liable in such circumstances for dishonest assistance[37] or the financial institution for unconscionable receipt of any money passed in breach of such a duty.[38]

LIABILITY TO EFFECT COMPENSATION UNDER THE FSMA 2000

24–17 The potential heads of civil liability under the FSMA 2000 were considered in detail in Ch.23—primarily in relation to liability under s.90 of the FSMA 2000. The potential heads of criminal liability under the FSMA 2000 and under other criminal law statutes are considered in detail in Chs 26 and 27.

(B) TORT

Introduction

24–18 This section considers the liabilities in tort which arise in relation to securities transactions. The principal focus of this section is on liability in tort connected with misstatements made in prospectuses and listing particulars: principally deceit and negligence in the preparation of those documents and liability to compensate the losses suffered by those who invest in those securities as a result. The order of the discussion is, to begin with, the most serious default in the form of deceit before moving on to negligence.

DECEIT—FRAUDULENT MISREPRESENTATION

The elements of the tort of deceit

24–19 Under the tort of deceit[39] a defendant will be liable to compensate losses suffered by a claimant in reliance on a false representation made by the defendant in circumstances in which the defendant knew that representation to be untrue, or was reckless as to its truth or falsity, and intended that the claimant would rely on that statement. If the representation was not deceitful in this fashion, then liability may arise under the tort of negligence, as considered in the next section of this chapter. The elements of the tort of deceit are considered in turn in the discussion to follow.

[34] See para.25–06.
[35] See para.25–15.
[36] See para.25–34.
[37] See para.25–35.
[38] See para.25–40.
[39] This tort is sometimes referred to simply as "fraud". See generally *Clerk and Lindsell on Torts*, Ch.18.

The need for a false misrepresentation

The nature of a false representation

24–20 The defendant must have made a false representation to attract liability for fraud under the tort of deceit. The misrepresentation may be explicit or it may be inferred from the circumstances as considered next. An inferred misrepresentation would arise where the defendant intended to create a false impression in the mind of the claimant. Thus in relation to prospectuses it is sufficient to constitute a representation as a false representation if the defendant intends that the claimant investor will form an impression from that representation which is untrue then that will constitute a false representation.[40]

Whether the false representation must be made explicitly

24–21 There are authorities under the general law of tort to the effect that a false representation must be made actively and consequently that "mere silence, however morally wrong, will not support an action of deceit".[41] That is, one may not be liable for deceit for failing to mention a fact because that does not constitute a representation of that fact. In the securities law context, however, as is considered below, the old cases on the preparation of prospectuses have created a golden rule which imposes an obligation of scrupulous honesty on those preparing prospectuses, together with liability where half-truths are used to conceal the true position. Therefore, as we shall consider, securities law will not permit silence about certain matters in a prospectus to exclude liability. More specifically, under securities regulation the persons responsible for a prospectus will be required to provide all of the information which would ordinarily be required by a reasonable investor and their professional advisors when making a decision whether or not to invest in the securities in question. Consequently, this is a further reason why omission of important material will not be sufficient. The question of omissions in cases on securities law is considered in greater detail below.[42]

Omissions of material and half-truths will constitute false representations

24–22 There are contexts under the general law of tort in which omissions of material have been taken to constitute false representations. So in *Peek v Gurney*[43] it was held by Lord Cairns that "a partial and fragmentary statement of fact" can have the effect that "the withholding of that which is not stated makes that which is stated absolutely false".[44] So, withholding a part of the truth with a view to

[40] See *Moens v Heyworth* (1842) 10 M. & W. 147, quoted in *Clerk and Lindsell on Torts*, para.18–04.
[41] *Bradford Third Equitable Benefit Building Society v Borders* [1941] 2 All E.R. 205 at 211, *per* Lord Maugham.
[42] See para.24–79.
[43] *Peek v Gurney* (1873) L.R. 6 H.L. 377.
[44] *Peek v Gurney* (1873) L.R. 6 H.L. 377 at 403.

http://www.pbookshop.com

any reasonable person as to make it impossible to hold that the defendant honestly understood the representation to bear the meaning claimed by him and honestly believed it in that sense to be true."

The defendant in an action for deceit will escape liability if they can prove that they did believe the fact stated, even though their belief was not based on reasonable grounds, for, if they believed the statement, fraud is negatived.[57] Again they will escape liability if they can prove that the claimant was not, in fact, misled. An example of this would be where the claimant knew the statement to be false when they applied for the shares.[58] However, it has been held that the defendant cannot avail themselves of the "audacious plea"[59] that the claimant might easily, by inquiry or otherwise, have ascertained that the statement was untrue.[60]

The defendant must have intended that the claimant would act on the representation

24–27 The defendant must have intended that the claimant would act on the representation for an action to lie in deceit.[61] It is sufficient that the defendant realises that the claimant will rely on the false representation.[62] Thus in preparing a prospectus, it will be sufficient to found liability on this part of the tort of deceit if the maker of the statement realised that the claimant would rely on that statement. This raises an issue, considered in greater detail below,[63] as to when it is reasonable to assume that a person will rely on a statement. In *Possfund Custodian Trustee Ltd v Diamond*[64] Lightman J. considered that the issue of shares ought not to be treated as though it was limited to any particular group of investors such that a prospectus could be relied upon by other investors acquiring their shares at a later date; whereas in *Al-Nakib Investments (Jersey) Ltd v Longcroft*[65] it was held that, because a share issue was intended to be a rights issue to a limited class of potential subscribers, therefore the issuer's duty of care was owed only to that limited class of subscribers and not to purchasers in the after-market. Thus at common law the context in which the prospectus is being put into circulation will be important.

The claimant must have been influenced by the representation

24–28 The claimant must have relied upon the representation when acquiring the securities in question. As Lightman J. put this matter in relation to offers of securities:

[57] *Derry v Peek* (1889) 14 App. Cas. 337; *Akierhelm v De Mare* [1959] A.C. 789.
[58] As in *JEB Fasteners Ltd v Marks Bloom and Co* [1981] 3 All E.R. 289; [1983] 1 All E.R. 583 CA.
[59] *Aaron's Reefs v Twiss* (1896) A.C. 273, *per* Lord Watson.
[60] See para.24–07 *et seq.*
[61] *Peek v Gurney* (1873) L.R. 6 H.L. 377.
[62] *Shinhan Bank Ltd v Sea Containers Ltd* [2000] 2 Lloyd's Rep. 406.
[63] See para.24–28.
[64] *Possfund Custodian Trustee Ltd v Diamond* [1996] 2 All E.R. 774; [1996] 1 W.L.R. 1351.
[65] *Al-Nakib Investments (Jersey) Ltd v Longcroft* [1990] 3 All E.R. 321.

"For the purpose of the torts of deceit and negligent misrepresentation, it is necessary to establish a material misrepresentation intended to influence, and which did in fact influence the mind of the representee and on which the representee reasonably relied."[66]

Significantly, the representation need only have been one of a number of factors which caused the claimant to act as he did, provided that it was a material inducement.[67] The statement must have been an inducement in the sense, in this context, of deceiving the claimant.

The standard of proof

24–29 The standard of proof for deceit is the ordinary test of the balance of probabilities.[68] There have, however, been judicial statements suggesting that the more serious the allegation of fraud then "the higher the degree of probability that is required",[69] which is a qualification which has been approved in relation specifically to securities transactions.[70]

Liability for fraudulent misrepresentation under the law of contract

24–30 This section has focused on the liability of the defendant in tort at common law. Liability for fraudulent misrepresentation already arises under the law contract under the Misrepresentation Act 1967. Much of the discussion of fraudulent misrepresentation is considered under that head.[71]

TORT OF NEGLIGENT MISREPRESENTATION

Introduction

24–31 This section considers the liability of people responsible for a prospectus (as described in Ch.21) for damages in tort for any negligent misrepresentation made in that prospectus which causes the claimant to suffer loss. In the decided cases specifically on offers of securities in this context, there has been an overlap in the judgments between fraudulent misrepresentations considered in the preceding section and negligent misrepresentations considered in this section. This section is focused on liability in the law of tort, whereas liability in contract for misrepresentation is considered later in this chapter.[72]

[66] *Possfund Custodian Trustee Ltd v Diamond* [1996] 2 All E.R. 774; [1996] 1 W.L.R. 1351; [1996] 2 B.C.L.C. 665, *per* Lightman J.
[67] *JEB Fasteners Ltd v Marks Bloom & Co*[1983] 1 All E.R. 583 at 589, *per* Stephenson L.J.; and see *Paul & Vincent v O'Reilly* (1913) 49 Ir. L.T. 89. See generally, *Clerk and Lindsell on Torts*, para.18–32.
[68] *Hornal v Neuberger Products Ltd* [1957] 1 Q.B. 247.
[69] *Hornal v Neuberger Products Ltd* [1957] 1 Q.B. 247 at 258, *per* Denning L.J.
[70] *Smith New Court Securities Ltd v Citibank NA* [1997] A.C. 254 at 274, *per* Lord Steyn.
[71] See para.24–106.
[72] See para.24–93.

http://www.pbookshop.com