

The FCA and the Non-Regulated

Introduction

In the wake of the financial crisis, the Financial Services Act 2012 set out a new system for regulating financial services in order to protect and improve the UK's economy. This included the evolution of the FCA from the FSA. Its purpose and role is to be commended a good many levels, not least as its primary objectives are to maintain the integrity of financial market and to ensure that customers' well being and interests are protected.

However, it is still open to businesses who are not "authorised" by the FCA to play a role in the market place, one example of which is alternative investments.

Anyone who has spent time on the FCA website and digesting the FCA's handbook will know that, without legal training and hundreds of hours of research, it may resemble a maze containing a myriad of restrictions that are all too easy to contravene.

This brief article is to assist with an overview of how and why a person/firms who are considering entering the financial market on an unregulated basis - such as offering alternative investments - need to consider regulation from their very first steps.

Alternative investments

The fact is that there are a number of people who are fortunate enough to have spread their investments for the future and have a portfolio of stocks, shares, property and money on deposit and now wish to experiment with more interesting investment options.

The number of people who now have the opportunity of investing as they see fit has increased dramatically due to the loosening of the pension rules on the 6th April 2015 to allow those over 55 to release funds from their pension and invest as they wish.

An alternative investment is an investment in classes of assets other than there traditional pension, stocks, bonds and cash deposits. Examples are varied but range

from investments in precious metals, wine, classic cars to more complex investment vehicles in private equity and distressed securities.

The positives include the possibility that such investments can yield a much higher rate of return. For example, if a person had invested in a well chosen classic Aston Martin in the last few years they are likely to have seen their investment rise by at least 50%.

However, there are negatives. The value of the investment can substantially reduce due to the vagaries fashion and taste. Moreover, most of the firms dealing with such investments are not regulated by the FCA and thus the investor does not have the reassurance of monitored quality and the recourse back to the Financial Ombudsman as a last resort.

The FCA and Legislation

The FCA have acted on their stated intention that they would become more aggressive in respect of financial regulation and their investigations and enforcement.

That is even more of an issue now given the amount of money now in the market place after the relaxation of the pension rules and the FCA is rightly concerned that there is even more attraction for the unscrupulous to become involved in the industry and seek to persuade the vulnerable to invest their hard earned savings into high risk schemes.

That said, there is still a niche market available to the non-regulated business to trade legitimately. The market opportunities are narrow but, with proper preparation, available and profitable.

Any business considering entering the financial market place must, and from the outset, consider the FCA's approach to regulation, its rationale, the limitations and criminal sanctions available under legislation such as the Financial Services Markets Act 2000 (FSMA).

The legal arena in question is massive and the outline below touches on just one pertinent issue and is one example of why scrutiny of the business from the start is crucial.

Financial Services Offences

The FSMA provided a general system for authorisation and exemption in the regulated field. Under section 19 of FSMA, a general prohibition exists in that, only those authorised or exempt can lawfully carry out regulated activity. A corporation may be permitted to carry on a regulated activity but all such businesses must be aware of the boundary between regulated and non-regulated areas. If the line is crossed without authorisation or exemption the possibility of criminal sanction may ensue, the punishments being an unlimited fine and up to 2 years imprisonment.

A person who contravenes the general prohibition is guilty of an offence as is an unauthorised person who is not exempt, but who describes himself as being authorised or exempt. Further contravention occurs where a person who "behaves or otherwise holds himself out in a manner which indicates, or which is reasonably likely to be understood as indicating, that he is" either authorised or exempt.

Financial Promotion Offences

Under section 21 of the FSMA, a person must not, when acting in the course of business, communicate an invitation or inducement to engage in investment activity, unless he is authorised or the content of the communication is approved by an authorised person. Contravention of this may result in an unlimited fine and 2 years imprisonment on indictment.

“Engaging in investment activity” under section 21 (8) means:

- (a) entering or offering to enter into an agreement the making or performance of which by either party constitutes a controlled activity; or*
- (b) exercising any rights conferred by a controlled investment to acquire, dispose of, underwrite or convert a controlled investment.*

Introducing, or informing, a person of an investment opportunity is not a regulated activity. However, a pertinent question is to when is a person, in the course of business, communicating an invitation or inducement as opposed to distributing information or introducing people to the topic.

Guidance on “advising” and “arranging” can be found by looking at Articles 53 and 25 of the Financial Services and Markets Act 2000 (FSMA) (Regulated Activities) Order 2001 (RAO).

Under Article 53 of (RAO), "Advising" a person becomes a regulated activity if,

- a) the advice is given to the person in his capacity as an investor or potential investor (or to that person's agent) and secondly,
- b) that the advice is advice on the merits of his doing any of the following - buying, selling, subscribing for or underwriting a particular investment which is a security or contractually based investment or exercising any right conferred by such an investment....

The definition as to what amounts to advice is wide and the concern in many cases is that the FCA may take the view that a company's activities are tantamount to giving such advice and arranging in investment deals.

Collective Investment Schemes

An example of the level of care that is needed from the outset is whether the business is in fact a "collective investment scheme" ("CIS") within the meaning of section 235 of the *Financial Services and Markets Act 2000* (“FSMA”).

A CIS is an arrangement that enables a number of investors to 'pool' their assets and have these managed by an independent professional, such as a fund manager who will reduce risk by investing the pooled money in one or more types of asset.

Not all CISs need to be regulated (UCISs) but those which are not are subject to tight restrictions on marketing and are not usually open to investment by retail consumers. Generally speaking they are not available for investment by retail consumers because, by their nature, they are risky products.

An example of the care needed is that should a scheme be deemed in fact to be a CIS then enormous consequences may follow. Firstly the establishment, operation and winding up of will be, by virtue of Articles 4 (2) and 51 (1) (a) of the *Financial Services and Markets Act 2000 (Regulated Activities) Order 2001* - "regulated

activities" within the meaning of section 22 (i) (b) of FSMA; and - by virtue of section 19 thereof – such activities cannot lawfully be carried out by unauthorised persons.

Consequently, the activity may attract the criminal offence and sanctions under section 23 FSMA (an unauthorised person to carry on a regulated activity in the UK) and, subject to exceptions, associated financial promotion offences (ie/ where a person in the course of a business to communicate an invitation or inducement to engage in investment activity).

Moreover, where an agreement by an unauthorised person in the course of carrying on a regulated activity is unenforceable and entitles the other party to recover money or property transferred or compensation for loss (section 26). Further, section 382 (d) of FSMA enables the court to require persons who have contravened the Act, or been knowingly concerned in a contravention, to make appropriate restitution to investors who have suffered loss. Those who have operated and/or promoted the schemes may also be liable to prosecution under s 397 of FSMA in respect of what the FCA claims were misleading statements which led investors to invest.

Conclusion

The advised approach to any person considering becoming involved in the financial market place as a non-regulated person or business, such as the provision of alternative investments, is to acknowledge the role of the FCA and obtain specialist advice on the complexities of the regulation - even though they consider it may not apply to them.

The best course of action is for the regulation and limitations to be embraced. This may sound curious to the non-regulated but it makes sense.

Firstly, one might assume that anyone considering making a significant alternative investment is likely to know of the FCA and have visited the FCA's website. If so they will be wary of a non-regulated business and will need to be re-assured that their best interests are at the forefront of the business.

Secondly, one should assume that sooner rather than later, the FCA's eye will be cast over the business. Where businesses have failed to obtain proper legal consideration as to their business affairs it may often be too late to rectify the consequences.

Thirdly, the rationale of the regulation protects not only the customer but also the business. When businesses can address and evidence that they pass threshold tests as to their integrity, management and control, market conduct and customers' interests, they are likely to be able to address any concerns the FCA may have of them, such as demonstrating that the customer was fully informed and aware before they exercised their choice.

Lastly, the need for a thorough assessment at an early stage may be underscored by the fact that the ramifications of a mistaken approach can lead to possible custodial sentences, unlimited fines and compensation to paid to customers,.

Accordingly, any person who considers that they are in a business that may be scrutinised by the FCA should consider how best they can in fact conform to regulation despite not being regulated with specialist legal advice either from the outset or as soon as practicable.

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