Feature

KEY POINTS

- This article discusses a series of powerful statutory provisions that enable contracts to be struck down for non-compliance with FSMA and only enforced in the court's discretion by reference to what is just and equitable.
- The arguments could deal a knock-out blow in a dispute and so are essential reading for commercial litigators. For non-contentious lawyers, the issues raised are also worth considering since they underline the importance of FSMA and the article touches on some suggested ways to pre-empt possible challenges.

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Financial services law as a sword: cutting down contracts

The article sets out how contracts can be rendered unenforceable by reason of a breach of the Financial Services and Markets Act (2000) (FSMA) and highlights an important – and perhaps underused – avenue of attack to be considered by commercial litigators dealing with cases in the financial services sector. The article also identifies possible issues for those responsible for drafting and advising on agreements potentially related to regulated activities.

ACTING WITHOUT PERMISSION AND UNENFORCEABILITY OF CONTRACT

The general prohibition

S.19 FSMA states:

'19.— The general prohibition.

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

(a) an authorised person; or
(b) an exempt person.

(2) The prohibition is referred to in this Act as the general prohibition.'

There are serious consequences for a breach of the general prohibition and a person who contravenes it is guilty of a criminal offence and liable to a fine and/or a maximum of two years in prison (s.23 FSMA).

S.400 FSMA provides that company officers can also be guilty of an offence by the body corporate if the offence is committed with their consent or connivance or is attributable to any neglect on the part of the company officer. A company – and the company's officers – are therefore likely to view extremely seriously a suggestion that there has been a breach of the general prohibition.

S.23(3) of FSMA provides that in '… proceedings for an authorisation offence it is a defence for the accused to show that he took all reasonable precautions and exercised all due diligence to avoid committing the offence'.

Whether or not a person is carrying on a "regulated activity" can be a complex issue and is a specialist area of the law. Financial services regulatory lawyers are frequently asked to advise on whether or not some form of authorisation is required (eg whether or not a particular service constitutes "advice", whether a property investment scheme by a syndicate constitutes a collective investment scheme etc).

Putting exempt persons to one side for a moment (eg appointed representatives), the central issue in determining whether or not authorisation is needed is usually whether or not the activities were regulated activities within the meaning of The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the RAO). This is because: a regulated activity is a specified kind of activity that relates to a specified investment or property of any kind and is carried on by way of business in the UK (s.22 FSMA); the RAO sets out specified kinds of activity that are regulated activities (eg accepting deposits, arranging deals in investments, advising on investments, establishing, operating or winding up a collective investment scheme). For the general commercial practitioner the fact that the issue of authorisation is a potentially difficult one is important to bear in mind because it is entirely possible for a person to have considered the issue with or without lawyers and wrongly concluded that they did not need to be authorised or exempt.

Effect on agreements

S.26 and s.27 FSMA provide:

'26.– Agreements made by unauthorised persons.

(1) An agreement made by a person in the course of carrying on a regulated activity in contravention of the general prohibition is unenforceable against the other party.

(2) The other party is entitled to recover–

(a) any money or other property paid or transferred by him under the agreement; and
(b) compensation for any loss sustained by him as a result of having parted with it.

(3) "Agreement" means an agreement–

(a) made after this section comes into force; and
(b) the making or performance of which constitutes, or is part of, the regulated activity in question.

(4) This section does not apply if the regulated activity is accepting deposits.
…

27.– Agreements made through unauthorised persons.

(1) This section applies to an agreement that–

(a) is made by an authorised person ("the provider") in the course of carrying on a regulated activity,
(b) is not made in contravention of the general prohibition,
(c) if it relates to a credit-related regulated activity, is not made in contravention of section 20, and
(d) is made in consequence of something said or done by another person ("the third party") in the course of–
(i) a regulated activity carried on by the third party in contravention of the general prohibition, or
(ii) a credit-related regulated activity carried on by the third party in contravention of section 20.

…

(1A) An agreement to which this section applies is unenforceable against the other party.

(2) The other party is entitled to recover–

(a) any money or other property paid or transferred by him under the agreement; and
(b) compensation for any loss sustained by him as a result of having parted with it.

…

(4) This section does not apply if the regulated activity is accepting deposits.
…'

S. 26 FSMA applies to agreements made by the unauthorised person (for example, a person enters into an agreement to provide advice in breach of the general prohibition for which they receive commission). S. 27 applies to agreements made through unauthorised persons (for example (and building on the example used in respect of s.26 FSMA) a person enters an agreement to provide advice in breach of the general prohibition as a result of which that person agrees with a properly regulated entity to buy or sell shares).

S.27 FSMA might be particularly useful to a potential claimant if (say) in the example given above the person providing advice had very limited means and no insurance but their advice had caused the client to place trades with the authorised entity and suffer very significant losses on the stock market. In that scenario there might be scope to argue that the agreement with the authorised entity was unenforceable and the investor was entitled to recover money transferred under the agreement and compensation.

As one would expect there is a check on the power of these provisions. The consequence of an agreement made by an unauthorised person (s.26 FSMA) or through an unauthorised person (s.27 FSMA) is set out in s.28 FSMA:

'28.– Agreements made unenforceable by section 26 or 27 [: general cases]

(1) This section applies to an agreement which is unenforceable because of section 26 or 27 [, other than an agreement entered into in the course of carrying on a credit-related regulated activity]

(2) The amount of compensation recoverable as a result of that section is–

(a) the amount agreed by the parties; or
(b) on the application of either party, the amount determined by the court.

(3) If the court is satisfied that it is just and equitable in the circumstances of the case, it may allow–

(a) the agreement to be enforced; or
(b) money and property paid or transferred under the agreement to be retained.

(4) In considering whether to allow the agreement to be enforced or (as the case may be) the money or property paid or transferred under the agreement to be retained the court must–

(a) if the case arises as a result of section 26, have regard to the issue mentioned in subsection (5); or
(b) if the case arises as a result of section 27, have regard to the issue mentioned in subsection (6).

(5) The issue is whether the person carrying on the regulated activity concerned reasonably believed that he was not contravening the general prohibition by making the agreement.

(6) The issue is whether the provider knew that the third party was (in carrying on the regulated activity) contravening the general prohibition.

(7) If the person against whom the agreement is unenforceable–

(a) elects not to perform the agreement, or
(b) as a result of this section, recovers money paid or other property transferred by him under the agreement,

he must repay any money and return any other property received by him under the agreement.

(8) If property transferred under the agreement has passed to a third party, a reference in section 26 or 27 or this section to that property is to be read as a reference to its value at the time of its transfer under the agreement.

(9) The commission of an authorisation offence does not make the agreement concerned illegal or invalid to any greater extent than is provided by section 26 or 27.'

As set out in the relevant sections, the court is given discretion to uphold the agreement by reference to what is "just and equitable". In making that decision the court has to have regard to "the issue", which broadly speaking relates to knowledge of the breach of the general prohibition.

Even if the contract in question is unenforceable, s.28(7) provides that

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if the person alleging the agreement is unenforceable elects not to perform the agreement, he has to repay money etc, received under the agreement. An example of a situation where the sub-section might operate is if a person borrowed money secured against their residential home but then argued that the lender was carrying out the regulated activity of entering a regulated mortgage contract. If the lender was in breach of the general prohibition, the borrower might be able to elect not to perform the agreement and argue that interest or other sums agreed to could not be recovered from the borrower, although s.28(7) FSMA would suggest that a claim to retain the principal sum borrowed would not succeed.

One interesting example of a case in which s.28 FSMA was considered is *Helden v Strathmore*. In that case, Mr Helden argued that loans made to him were in breach of the general prohibition and so a charge on a property was not enforceable.

At first instance [2010] EWHC 2012 (Ch) it was held that there was a breach of the general prohibition (see ¶90 of the judgment) but that the agreement could be enforced. Although the issue at s.28(5) was a "weighty factor" it was not the only factor (see ¶¶99–100 of the judgment). Even if the agreement could not be enforced the lender could still have claimed, pursuant to s.28(7) FSMA, the return of the money. Ultimately, the judge concluded that the charge was enforceable against Mr Helden.

On appeal by Mr Helden (see [2011] EWHC 1321 (Comm)) one of the issues was the application to enforce the agreement (see ¶¶43–54 of the judgment). The Court of Appeal upheld the first instance finding that there had been a breach of FSMA but that the charge could be enforced.

The court left open the question of whether it was possible for a person to contend that he reasonably believed that he was not contravening the general prohibition by making an agreement, if he was wholly unaware of the existence of the prohibition at the time of the agreement. The court said at ¶¶46–47 of the judgment:

> 'It seems to me that there is considerable force in the simple linguistic point that a person cannot "believe that he [is] not contravening [a] rule", if he is wholly unaware of the rule. Believing that one is not doing something is simply not the same thing as not believing one is doing something: to believe wrongly that one is not committing an act requires a degree of knowledge as to what that act is or entails, whereas wrongly not believing one is committing an act requires a degree of absence of knowledge, which renders it easier to contend that it would apply where one is ignorant of the existence of the act.
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> Against that, there is some force in the point that it is unlikely that Parliament could have intended that a person who wrongly, but reasonably, believes that he is not contravening a statute should be better off than a person who was, reasonably, unaware that the statute applied. Having said that, the answer to that point may be that people who carry on regulated activity and are ignorant of the law, even if reasonably so, should be more at risk, because they are more of a danger to the public, than those who carry on such activity, and are aware of the law, and reasonably, albeit wrongly, conclude that it does not apply.'

The court weighed some of the arguments and as I have said preferred not to resolve this "difficult" issue because it did not need to do so in order to decide the case and considered further argument on the point was merited.

As the law stands, it is therefore arguable that a person who is completely unaware of the regulatory regime should not be able to say they reasonably believed they were not contravening the general prohibition. It may therefore be helpful for those entering into agreements and who had decided that authorisation was not required to be able to demonstrate that they were aware of the regime and had considered it.

There are similar provisions in respect of credit agreements (see also ss. 20, 23, 26A and 28A). In the case of otherwise unenforceable credit agreements the application for enforcement is made to the FCA and not the court by reference to what is just and equitable in the circumstances of the case. A person aggrieved by a determination of an application to the FCA under s. 28A(2)(b) or (3) may refer the matter to the Upper Tribunal.

SOME PRACTICAL CONSIDERATIONS

Whether or not an argument about the breach of the general prohibition is applicable to any particular case will depend on an analysis of the regulatory regime. For commercial litigators the statutory provisions identified above represent a potentially powerful tool in respect of contractual disputes. The consequences of a breach of the general prohibition (eg it being a criminal offence) and the fact that the agreement is only enforced at the discretion of the court could be a powerful incentive for settlement and avoiding the potential uncertainty of a trial.

For advisers and those drafting agreements, as ever, it is important to ensure that there is not a breach of the general prohibition and if there is the possibility that an issue is engaged that there is a clear record of the point being considered and the conclusions reached. If the existence of a breach of a general prohibition turns on the conduct of another party or facts within their knowledge, it is likely that consideration would be given to clear contractual basis clauses and undertakings to strengthen an argument for enforcement and possibly for an argument that the other party is estopped from relying on facts contrary to those contained in the agreement. ■

Further Reading:

- Collective investment schemes: a missed opportunity? [2012] 4 JIBFL 219.
- Regulated Activities under the Financial Services and Markets Act 2000 [2001] 7 JIBFL 303.
- LexisNexis Financial Services blog: trends in financial services enforcement.