EU legal commentary: Financial Services and Markets Tribunal considers risks of contravention of FSA Principle requiring skill, care and diligence in *Fox Hayes v Financial Services Authority*

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Abstract This piece reports a decision of the Financial Services and Markets Tribunal concerning a challenge to FSA enforcement action taken in respect of a UK firm of solicitors' approval of financial promotions made by unauthorised overseas firms promoting shares in unlisted companies to UK-based investors. In light of the shift in emphasis towards Principles-based regulation, the Tribunal's reasoning in relation to whether or not the firm had acted in breach of the second of the 11 FSA Principles for Business will provide some comfort for those faced with uncertainty about compliance under Principles-based regulation.

Keywords: *financial promotion, unauthorised overseas firms, 'boiler rooms', FSA Principle for Business 2 Due Skill Care and Diligence*

BACKGROUND TO THESE PROCEEDINGS

This reference before the Financial Services and Markets Tribunal was brought by Fox Hayes, a ten-partner firm of solicitors based in Leeds. In 2000, the firm had established an 'Entrepreneurs Club' to put unquoted companies wishing to raise capital in contact with potential investors. It was Mr Jones, the firm's compliance officer and a partner in the firm, who had responsibility for approving the promotional material circulated by these companies in accordance with Financial Services Authority (FSA) financial promotion rules. The potential investors to whom the material was sent were either clients of the firm or had asked to be included in the Entrepreneurs Club.

Between 2003 and 2004 the applicant approved a series of financial promotions on behalf of a number of overseas companies which were not authorised under the Financial Services and Markets Act 2000 to carry on regulated activities in the UK. These companies made financial promotions to private investors in the UK by sending letters offering free research reports (these reports themselves were approved by Fox Hayes) into UK public companies in which the investors receiving the letters already held shares. In responding to the letter and requesting a report, the investors thereby agreed to be contacted, without any further obligation, by the overseas investment companies from time to time in relation to further investment opportunities. Following such contact, if an investor were to invest in any of the unquoted companies being promoted, then Fox Hayes would act for the overseas company concerned and would draw up an investment agreement between it and the investor. The terms of that agreement contained risk warnings, risk awareness declarations on the part of the investor, and clear statements that Fox Hayes was not giving investment advice or making any warranty about the suitability of any shares bought. Fox Hayes also operated an escrow account into which investors paid their purchase money for any shares bought; the money was released at the instructions of the overseas companies only when investors received their share certificates.

Against the wider backdrop of mounting regulatory concern about the activities of what are commonly termed share-pushing 'boiler room' operations targeted at UK investors from overseas, the FSA issued an enforcement decision notice to Fox Hayes on 29th September, 2006, in respect of the firm's approval of financial promotions on behalf of the unauthorised overseas companies and imposed a financial penalty of £150,000. The decision notice stated that the firm had not taken reasonable steps to ensure that the promotions were clear, fair and not misleading, and that it had reason to doubt that the overseas companies would deal with the UK investors in an open and honest way.

The firm took issue with the FSA's findings by way of a reference to the Tribunal. The FSA responded to the challenge by raising two more allegations that it had not made in the original enforcement action: (1) that the applicant had breached financial promotion rules insofar as it had not arranged for the confirmation of the financial promotions to be carried out by an individual with appropriate expertise, and (2) that it had not conducted its business with due skill, care and diligence, thus being in breach of Principle 2 of its Principles for Business.

TRIBUNAL'S DECISION

The Tribunal stated that the decision revolved around the issues raised by the following four questions:

- Did Fox Hayes take reasonable steps to ensure that the promotions were clear, fair and not misleading?

- Did Fox Hayes have reason to doubt at any stage that the overseas companies whose promotions they approved would not be honest and reliable in the way in which they dealt with the UK investors?
- Did Fox Hayes apply appropriate expertise to its approval of the financial promotions?
- Did Fox Hayes conduct its business with due skill, care and diligence?

On the first point, the FSA asserted that the letters sent out to UK investors amounted to more than mere invitations to send for free research reports into UK companies in which the investors already had shares; rather, the FSA argued, they amounted to financial promotions, as they were inducements to the investors to engage in any subsequent share purchases that would result from further contact with the sender of the letter. But the Tribunal saw this as far too loose an interpretation of the concept of 'inducement' in the definition of financial promotion. There was insufficient causal proximity between those early-stage letters and any subsequent share purchases from the overseas companies sending those letters to be able to say that the initial letters were an inducement to buy those unquoted shares at a later date. It said:

> 'We accept that [Fox Hayes] knew that the whole purpose of the offer of free research reports was to obtain the consent of investors to be contacted by the overseas companies who would then try to sell the [various shares subsequently brought to the attention of the UK investors] to the investors. However, there was nothing in the Conduct of Business Rules which would prevent this and there was nothing in the Rules to prevent the overseas companies from gaining access to the United Kingdom investors in this way.'

On the second issue, the Tribunal ruled that Fox Hayes had no reason to entertain any doubt that the overseas companies would deal with UK investors in an open, honest and reliable way until November 2003. It was only at that stage that the first shadows of doubt ought, perhaps, to have occurred to the firm. Indeed, by November 2003 there had been a rising volume of complaints made to Fox Hayes about the activities of these overseas companies, there had been press correspondence about the activities of one of the Spanish overseas companies for whom Fox Hayes acted, as well as a notice from the Spanish financial regulatory authorities stating that neither the particular company nor any individuals concerned with it were authorised under Spanish law to conduct investment business. All these factors, the Tribunal concluded, when viewed cumulatively, should at this stage (but not before) have given rise to doubts on the part of Fox Hayes about the extent to which its overseas client firms would deal with UK investors openly, honestly and reliably.

In relation to the third issue, that the firm had not applied appropriate expertise to its approval of the financial promotions on behalf of the overseas companies, the Tribunal disagreed. Mr Jones, the firm's compliance officer, had been responsible for the approval of the material and he was a solicitor of some 20 years' standing, with previous experience of the approval of financial promotions through his operation of an investors' network for the firm. He had also researched the relevant regulatory rules, consulted the FSA, attended FSA seminars on financial promotion, checked all documents carefully, and no money had been lost by investors as a result of his actions.

The FSA argued that the firm had breached the second of its 11 general Principles for Business, which requires that a firm '. . . must conduct its business with due skill, care and diligence', in two respects. First, the FSA argued that Fox Hayes had not made adequate enquiries about the overseas companies for whom it acted, and secondly, that it failed to advise those companies as to the legality of the telephone calls made to UK investors.

However, the Tribunal disagreed and stated that, while perhaps enquiries about the companies could have been followed up slightly more closely, in light of the weight the firm was entitled to attach to the contact who had recommended these companies to it, and the references it had taken up and enquiries that it had made of them, no want of skill, care and diligence was evident from the enquiries it made. As to whether or not there was a lack of skill, care and diligence in any legal advice the firm had or should have given and did not give to the overseas companies before acting for them, the Tribunal reviewed carefully the legal position under the Financial Services and Markets Act 2000 (FSMA 2000) on financial promotion and the definition and ambit of carrying on regulated activities. However, it noted that it could not reach any conclusion on this issue without deciding the substantive legal issue of whether or not those overseas companies were in contravention of the FSMA 2000 — had they contravened the prohibition on financial promotions by unauthorised persons and had they contravened the general prohibition on carrying on investment business in the UK without appropriate regulatory authorisation or outside of any applicable exemption? The FSA had specifically invited the Tribunal to decline to make a ruling on these issues which went to the legality or otherwise of the conduct of the overseas companies. Even if the FSA had not ruled these issues out of the ambit of the reference, the Tribunal stated that it would have declined to decide them as they were beyond the reference before it. Therefore, the FSA could not have it both ways and could not claim that a breach of Principle 2 was committed by the firm's failing to advise on the application of law that was not relevant.

PRACTICAL IMPLICATIONS

The FSA has often stated the advantages of 'Principles-based' financial regulation as it has sought to justify and explain its dominant regulatory philosophy to firms. One of those advantages is that it puts the onus on the firm to whom the principles apply to consider and assess the risks to the FSA's four statutory objectives when faced with a decision within the firm's business which may pose a risk to any of those objectives. It thus, to some extent, delegates regulatory responsibility to the level of the regulated, and this can give rise to tensions where the application of a legal provision or principle is genuinely uncertain. The great danger for firms is that, in its decisions to take enforcement action based on contravention of generally phrased principles and rules, the FSA may operate with a degree of hindsight with the advantage of facts and circumstances that were either not apparent to the firm at the time it was struggling to reach a compliance decision within its business, or had not even materialised at that earlier point in time. The Tribunal in this decision showed great awareness of that danger and examined in great detail the steps taken by Mr Jones in his interpretation of the FSA's public pronouncements on the risks and dangers of boiler room operations, as well as his active discussions during and after FSA monitoring visits, requests for guidance from and correspondence with the FSA as he tried to better inform himself of the risks of the firm acting for and continuing to act for these overseas companies. In deciding that further submissions should be made on the appropriate level of penalty (it thought £150,000 excessive and £70,000 more of an appropriate level) the Tribunal commented that, where specific help and guidance had been sought by Mr Jones from the FSA as to whether there were any regulatory concerns, given the mounting publicity being given to the activities of unauthorised overseas firms and their potential for use as high pressure-selling boiler rooms, such guidance and help from the regulator was not as forthcoming as it could have been. Firms needing to take commercial decisions within the shadow of real regulatory uncertainty and worried about the risks of subsequent hindsight-ridden enforcement action predicated on contravention of general and open Principles would do well to take heart from the Tribunal's view of Mr Jones' conduct. It seems that a request for specific guidance from the FSA about aspects of the firm's business that potentially give rise to regulatory concern, if coupled with real active attempts on the part of the firm itself to reach a judgment on applicable regulatory principles and rules, will help the firm sustain an argument that it has exercised the level of skill, care and diligence required by regulatory principle. After all, if making a considered request of the regulator for specific guidance is not taking care to minimise risks to its regulatory objectives — what more can be done in an uncertain world in order to minimise regulatory and legal risk?

NOTE

The FSA announced on 10th April, 2008 that it has applied for permission to appeal against this decision.