HIGH COURT CONSIDERS SECTION 39 FSMA & ANDERSON v SENSE NETWORK

In *KVB Consultants v Jacobs Hopkins McKenzie and others* [2023] EWHC 1686, the High Court (Mr Paul Stanley KC sitting as a Deputy Judge) considered *Anderson v Sense Network* [2019] EWCA Civ 1395, and the question to what extent the defendant had successfully managed to limit its responsibility for the acts and omissions of its appointed representative ("AR"). This is the first case to consider the distinction made in *Anderson* between what the AR is permitted to do and how it should do it. Limitations on what the AR is permitted to do mean that, if the AR acts outside those limitations, liability does not attach under s. 39 of the Financial Services and Markets Act 2000 ("FSMA").

The question arose on a summary judgment application in a case arising from property development investments that failed. The investments had been conceived, promoted, and run by Jacob Hopkins McKenzie Ltd ("JHM"). The Claimant investors applied for summary judgment against the twelfth Defendant, Kession Capital Ltd ("KCL"). JHM had, for a period, been KCL's AR pursuant to s.39 of FSMA. KCL contended that the terms of the appointed representative agreement meant that it was not liable for what JHM had done.

Statutory Framework:

As is well known, FSMA stipulates that, in order to carry on a 'regulated activity' (i.e. an activity specified in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544)), a person has to be authorised by the Financial Conduct Authority ("FCA"), or has to be exempt from the need for authorisation. Those two categories of person are referred to in s.19, respectively, as 'authorised persons', and 'exempt persons'.

An 'appointed representative' of an authorised person is an exempt person. Somebody can become an AR of an authorised person by virtue of the following subsections of s.39 of FSMA:

"…

(1) If a person (other than an authorised person) —

(a) is a party to a contract with an authorised person ("his principal") which—

(i) permits or requires him to carry on business of a prescribed description, and

(ii) complies with such requirements as may be prescribed, and

(b) is someone for whose activities in carrying on the whole or part of that business his principal has accepted responsibility in writing, he is exempt from the general prohibition in relation to any regulated activity comprised in the carrying on of that business for which his principal has accepted responsibility.

…

(2) In this Act "appointed representative" means –

(a) a person who is exempt as a result of subsection (1),

…

(3) The principal of an appointed representative is responsible, to the same extent as if he had expressly permitted it, for anything done or omitted by the representative in carrying on the business for which he has accepted responsibility.

…"

In *Anderson & Ors v Sense Network* the Court of Appeal held (in summary) that a principal could lawfully limit its responsibility for the acts of its AR by granting permission only in relation to part of a generic category of business. The Court held that sub-sections (1) and (3) had to be read together and said that the ability to permit part only of a class of business arose from the words "the whole or part of" in sub-section 1.

The Court drew a distinction between limitations as to what the AR could do (which are effective to circumscribe the ambit of the permission) and how the AR should do it (which are not effective in the same manner). Restrictions on how business is to be done are matters between the principal and the AR inter se, and do not affect liability under s.39. David Richards LJ said that this distinction should only prove troublesome in a rare case.

Facts:

JHM became KCL's AR in June 2015. The AR agreement ("the Agreement") contained the following definition of 'Relevant Business':

"Relevant Business means regulated activities which…[JHM]*…is permitted to carry out under this Agreement which are subject to the limitations of the Appointor's part IV permission as detailed in Schedule 5. For the avoidance of doubt, the AR is not permitted to carry out any investment management activities.*

…[KCL]*…is permitted to market and promote its services, arrange business and give advice.*

…[KCL]*…will conduct business with professional clients, elective professional clients and eligible counterparties.*

…[KCL]*… is not permitted to conduct any business with retail clients.*

The Appointor acknowledges that…[KCL]*…will offer advisory and arranging services to third party investors with regard to residential property investment. There is no pooling of capital and no CIS"*

CIS means a collective investment scheme, an investment arrangement whose definition is set out in s.235 of FSMA, and which was analysed and considered by the Supreme Court in *Asset Land Investment PLC and Another v The Financial Conduct Authority* [2016] UKSC 17.

Schedule 5 of the Agreement listed certain regulated activities that KCL was permitted by the FCA to carry out, and certain regulated activities that it was not permitted to carry out. KCL, according to Schedule 5, was not authorised to *"conduct any investment management activities", "operate a collective investment scheme"* or *"give advice to retail clients".* KCL was, however, permitted to carry out *"advising on ... rights to or interest in investments ... share ... unit"*, and "*arranging ... deals in investments ... rights to or interests in investments ... share ... unit"*.

It was common ground that JHM was not an authorised person and, but for the Agreement, it would not otherwise have been an exempt person.

The investments that JHM promoted to the various Claimants operated as follows. JHM would identify a property to develop. The investors would pay cash into a solicitor's client account, and a special purpose vehicle would be set up to purchase the property. The shares in the special purpose vehicle were held by Mr Andrew Callen, the controlling mind of JHM. The investors were provided with documents that purported to show that the property was being held on trust on their behalf. Mr Callen took the view that this structure prevented the schemes from being collective investment schemes.

However, as the judge put it (at paragraph 16iv): *"What is clear — and not in dispute — is that the investors were given to understand that their investment took the form of the acquisition of a physically undivided interest in the development land which would in due course be sold for their benefit. They did not expect to play any significant part in the day-to-day management of the land, which was to be left to JHM"*.

At the summary judgment hearing, there was no real argument by KCL against the Claimants' allegation that the failed investments constituted collective investment schemes. In any case, the judge had no hesitation in concluding that the investments were indeed collective investment schemes.

It was accepted by KCL that it did not have, and had never had, the relevant regulatory permissions, in the judge's words *"to operate…promote…or approve* [the promotion of]*"* collective investment schemes.

Decision:

The Claimants relied on three causes of action. Two of those – which related to an alleged breach by KCL of the FCA's rules on supervision, in that it failed to detect that the schemes were collective investment schemes, and unlawful approval by KCL of promotions of the investments in question, such that it was liable to the Claimants by virtue of s.241 of FSMA – were essentially dismissed because they could not be decided on a summary basis.

The claim under s.241 failed on consideration of the facts and the imprecise pleading thereof, since it did not meet the summary judgment threshold.

The supervisory claim raised triable issues: the Court rejected the Claimants' case that a principal could never rely on information and opinions provided to it by its own AR as to the legal status and features of the product with which the AR was dealing. Since the product here was a complicated one, the law was not settled pre-*Asset Land*, and since Mr Callen was a legally qualified and experienced professional, it might be that at trial KCL would show that it was reasonable for it to have relied on his views as to whether the schemes were collective investment schemes.

It is the claim brought under s.39(3) of FSMA which is of greater interest.

The investors argued that JHM's having promoted the investment schemes fell within the scope of the business for which KCL had agreed to accept responsibility under the Agreement.

KCL's reply was that the Agreement expressly excluded collective investment schemes from the business for which KCL had accepted responsibility. The whole premise of the Agreement was that the investments of the type that the Claimants had entered were not collective investment schemes.

The judge differentiated between two parts of JHM's business activities regarding the investment schemes. The first was operating collective investment schemes. The second was promoting and marketing such schemes.

As regards operating collective investment schemes, the judge found that this was not something for which KCL had accepted responsibility. There were two reasons for that conclusion. First, on its true construction, the Agreement did not include operating a collective investment scheme within the activities for which KCL had accepted responsibility. Secondly, s.39(1)(a) of FSMA specifies that the business governed by an appointed representative agreement has to be an activity that is *"prescribed"* by virtue of the Financial Services and Markets Act 2000 (Appointed Representatives) Regulations 2001. Operating a collective investment scheme is not an activity prescribed by the regulations, and so could not have been something for which KCL had accepted responsibility.

The second aspect of JHM's business in relation to the schemes – which, in the judge's words, at paragraph 53*"lay not in operating the schemes but in promoting and marketing them, and encouraging investors to participate in them"* – would, however, constitute carrying on prescribed activities. Had KCL accepted responsibility for JHM conducting activities of this kind?

KCL argued that it had not done so, for two reasons. The first of these was the fact that, on the Claimant's case, they were themselves retail investors. The Agreement, KCL pointed out, forbade KCL from conducting business with retail clients. Secondly, KCL submitted that collective investment schemes were expressly excluded from the definition of 'relevant business' under the Agreement.

The judge rejected these submissions. He found that stipulating the type of clients with whom JHM was allowed to carry on business amounted to a requirement as to *how* JHM should go about its business, rather than precisely *what* business it was permitted to carry on under the Agreement, within the meaning of David Richards LJ's distinction in *Anderson*. The judge also disagreed with KCL's arguments on the construction of the Agreement. When construed against the factual context, the judge found that it was clear that the Agreement had envisaged JHM marketing schemes of precisely the kind that the Claimants had invested in (and in respect of which they were bringing proceedings). The fact that JHM and KCL mistakenly held a common belief that those investment arrangements did not amount to collective investment schemes was irrelevant. It was noteworthy, in the judge's view, that there had not been any significant change in the nature of the schemes from what had been envisaged by JHM and KCL at the time that they entered into the Agreement. They had simply been labouring under the common illusion that they did not amount to collective investment schemes.

Having established that promoting and marketing the schemes was business for which KCL had accepted responsibility, the judge moved on to consider whether that gave rise to any liability. The judge found that, in respect of schemes that had been marketed after summer of July 2016, Mr Callen of JHM had had enough information before him to realise that the investment schemes potentially were collective investment schemes, such that continuing to market them thereafter was a breach of JHM's obligations under the FCA's Conduct of Business Sourcebook. KCL was liable for such breaches by JHM.

As regards promotion of the schemes: the judge had already found that the investments constituted collective investment schemes. Promoting a collective investment scheme is prohibited by virtue of s.238 of FSMA; and s.241 provides that a breach of that prohibition gives rise to a claim for breach of statutory duty. Accordingly, KCL was liable for JHM's having promoted the investment schemes, save for any activities by JHM to promote schemes that might have occurred after the date that the Agreement was terminated.

<u>Discussion:</u>

The decision shows that the Courts are willing to scrutinise, and construe appointed representative agreements, and make determinations on their construction, even on a summary basis. It raises interesting questions as to how far the exercise of interpreting such agreements should be pursued in a purely objective fashion, or else should take into account subjective, but mistaken, views, shared by the parties, as to the nature of the business for which the principal is accepting responsibility.

The distinction between delineating what business a principal has accepted responsibility for, and stipulations by the principal as to how the appointed representative is entitled to go about that business, remains the key for establishing the parameters of the business for which the principal has accepted responsibility.

It is significant that the judgment specifies that, in determining this question, the Court should focus on substance, not form, and should do so in a pragmatic fashion. In the judge's

words (at paragraph 54): *"The line between "how" and "what" is drawn not by considering the way a particular limitation is expressed. Skilful drafting can easily express instructions about an agent's conduct ("do not market to retail clients") or legal categorisation ("market only if the investment is suitable") as if they were limitations on authority ("you may market only to professional clients for whom the investment is suitable") or on the scope of the business ("relevant business is marketing suitable investments to professional clients"). What matters is the commercial activity ("marketing"), and its substance"*.

Finally, it may be thought that the case demonstrates that David Richards LJ's confidence that the what / how distinction will only cause trouble in a rare case is somewhat misplaced.

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