PART I

Evolution of capital markets regulation, FSA and the European single market

1 Introduction

> It is not the purpose of this Treatise to make its totality understandable to . . . those who have not engaged in any study other than the science of the Law – I mean the legalistic study of the Law. For the purpose of this Treatise . . . is the science of Law in its true sense . . . But . . . nor should he hasten to refute me, for that which he understands me to say might be contrary to my intention. He thus would harm me in return for my having wanted to benefit him and would repay evil for good.[1]

That is the sentiment. Now, the insight. Law is applied sociology, the rules constructed by people in order that they might regulate their behaviour for the benefit of all within their particular social grouping. The sociological fact of acceptance, by-and-large, within that grouping is, notwithstanding any lack of definition of a 'formal' process, sufficient for those rules to be called 'law' and, to that extent, the psychological reason for that acceptance (and the answer to the question: Why is law binding?) does not have to be answered. Regulation, including the regulation of the Capital Markets, is law. It has legal consequences in that it affects the rights and obligations of the citizen (the regulated) and the Government (the regulator), which rights and obligations are enforceable through 'legal' process, notwithstanding any attempt by the regulator to circumvent or, at least, be creative with that process (2.5.5, 2.5.8). It follows that you can understand the content of a particular regulation or set of regulations only if you understand five extraneous facts.

First, you must understand the social context in which the rules were formulated. Regulation, by definition, regulates something and in the Capital Markets that 'thing' is an economic operation (2.4.4). Unless you understand that operation, the working of the rule is unintelligible. Second, you must understand the reason why the rule was considered necessary in the first place, in other words the policy on which it was based. But that policy is never dreamt up by the regulator in a vacuum. It is always a reaction to an historical event or series of events (see, for example 2.5, 5.1 and 12.4). You, therefore, need to understand the regulator's perception of both those events and their consequent requirements. Third,

[1] *The Guide to the Perplexed*, Moses Maimonides, Vol. I, pp. 5, 15, Chicago, 1983. Original, 12th century.

that policy, having been so formulated, requires articulation in a written rule. The draftsperson, usually a lawyer, will represent the rule through analogues to the general civil and criminal law in which he or she was trained. You need to understand that resemblance to properly construe the rule (see, for example 6.3.1.2, 7.1.1, 7.2.1, 8.4.1 and 10.5.1.1). Moreover, fourth, and in a sense this is an aspect of the third point, the rules so drafted will be part of the contemporaneous legal and regulatory infrastructure, perhaps modifying and/or extending other rules, although in all cases building upon that infrastructure and requiring you to have a broader understanding of those connected areas of law (see, for example, 11.1, 11.2 and 12.5). All legal rules are, of course, of two types: 'facilitative', allowing people to do that which, without the rule, they could not have done (in the form: 'If Y, then X'. See, for example, Figure 4 in 3.2.1, and 3.2.1.1); and 'regulatory', directing behaviour under certain conditions (always in one of the forms: 'Do X'. 'Do not do X', 'Do X unless Y', 'Do not do X unless Y', 'If Z do X unless Y', 'If Z do not do X unless Y'. For a schematic example, see 4.1). And, fifth, the rule does not remain static but, over time, evolves in relation to the social evolution of the behaviour so facilitated or regulated (see, for example, 6.3, 13.2). The historical development of the 'living' rule must, therefore, be understood in order to understand its current formulation and its effect upon the Capital Markets.

Stating all of this another way, the challenge with law, and the regulation of the capital markets is no exception, is to understand what it means in any particular context (fact pattern). Obviously, you can understand a rule only if you understand its meaning, but the rules for the meaningful construction of law themselves form a subject in their own right[2] and, like any set of rules, need to be understood in the same way (even though this rule set is largely judge-made law). These rules, which are applied to primary and secondary legislation indiscriminately[3] (always remembering that the regulators' rules in the capital markets are, in effect, secondary legislation), are based on an innate legal conservatism:

> the British constitution . . . is firmly based upon the separation of powers: Parliament makes the laws, the judiciary interprets them. When Parliament legislates . . . the role of the judiciary is confined to ascertaining from the words that Parliament has approved as expressing its intention what that intention was, and giving effect to it. Where the meaning of the statutory words is plain and unambiguous it is not for the judges to invent fancied ambiguities as an excuse for failing to give effect to its plain meaning because they themselves consider that the consequences of doing so would be inexpedient, or even unjust or immoral.[4]

[2] See Bennion *Statutory Interpretation*, 4th edn., LexisNexis, 2005.
[3] Bennion, section 60. [4] *Duport Steels Ltd.* v. *Sirs* [1980] 1 AER 529 at 541.

Thus:

> in a society living under the rule of law[5] citizens are entitled to regulate their conduct according to what a statute has said, rather than by what it was meant to say or by what it would otherwise have said if a newly considered situation had been envisaged.[6]

As a result, '[w]e often say that we are looking for the intention of Parliament but that is not quite accurate. We are seeking the meaning of the words which Parliament used. We are seeking not what Parliament meant but the true meaning of what they said.'[7] 'The question of legislative intention is not about the historical or hypothetical views of legislators, but rather concerns the meaning of words used in a particular context.'[8] It is in this context that *Pepper* v. *Hart*[9] must be understood. The House of Lords stated that '[t]he days have long passed when the Courts adopted a strict constructionist view of interpretation which required them to adopt the literal meaning of the language. The courts now adopt a purposive approach which seeks to give effect to the true purpose of legislation and are prepared to look at much extraneous material that bears upon the background against which the legislation was enacted.'[10] But this is not a general purposive approach such that in all cases 'a construction which would promote the general legislative purpose underlying the provision . . . is to be preferred to a construction which would not'.[11] Rather, if 'there was an ambiguity in the meaning of the provision . . . the purpose of the provision as revealed by the legislative history could resolve that ambiguity' and, in such circumstances, 'the judge may look beyond the four corners of the statute to find a reason for giving a particular interpretation to its words'.[12] There are four, somewhat limiting, conditions for applying this: '[1] [T]he enactment . . . is ambiguous or obscure, or the literal meaning leads to an absurdity. [2] The statement must be made by or on behalf of the Minister . . . who is the promoter of the Bill [i.e. is contained in *Hansard*]. [3] The statement must disclose the mischief aimed at by the enactment, or the legislative intention underlying its words. [4] The statement must be clear.'[13] Thus, '[e]nacting history is never of binding or compelling authority'.[14]

There are a number of reasons why, certainly in the context of the regulation of the Capital Markets, such a limited approach cannot continue. First, the law is increasingly based on European Directives and Regulations and here the national Court must interpret national law 'in the light of the

[5] A further question in such a society is how the rules should be made and this relates to the democratic delegation of authority to the regulator without further express acceptance by the regulated (2.5.4). [6] *Stock* v. *Frank Jones (Tipton) Ltd.* [1978] ICR 347 at 354.
[7] *Black-Clawson* v. *Papierwerke* [1975] AC 591 at 613. [8] *Cross*, p. 26.
[9] [1993] 1 AER 42. [10] *Ibid* at 50.
[11] The Interpretation of Statutes, LC No. 21, 1969, App. A, Clause 2 (a). [12] *Cross*, p. 19.
[13] Bennion, section 217. [14] *Ibid*, section 230.

wording and the purpose of the directive in order to achieve the result pursued by the latter'.[15] Accordingly, '[i]n construing Community law operating . . . in the United Kingdom the system of interpretation to be used by our courts is that practiced by the [Court of Justice of the European Community] and not our own system based in the common law'.[16] This system 'applies teleological . . . methods to . . . interpretation . . . It seeks to give effect to what it perceives to be the spirit rather than the letter of the [rule].'[17] The spirit is necessary to give effect to the underlying purpose of the Community as a Single Market (2.6) and, hence, '[t]he CJEC method may be called Developmental construction because in achieving the "spirit" it is always ready to depart from the text . . . It uses the text merely as a starting point, with the aim of developing the particular piece of Community law . . . within the context of the grand design',[18] 'the . . . purpose . . . behind it'.[19] Second, the rules operate on a day-to-day basis in a prudential supervisory context where the relationship between the regulated (the firm) and the regulator (the FSA) is subject to no further legal process. In this environment the intentions, interpretations and policies of the regulator are paramount. Third, this is re-enforced by the current, evolving, environment of 'principles-based regulation' which is characterised by the FSA as 'a shift . . . from managing a legally driven process of compliance with detailed rules to managing the delivery of defined outcomes in a more flexible regulatory environment'.[20] The FSA's views on the meaning of these vague, high level, principles is articulated, if at all, only in material extraneous to the rules (2.5.8). Fourth, when the Courts decide upon the standards required by such rules expressed as 'outcomes' it seems only natural that they would at least have regard to the views of FSA (however expressed). Even if the Court is unable to find an 'ambiguity' within the *Pepper* v. *Hart* doctrine, it ought to operate in this manner because as regulator, and self-styled standard setter for fast-moving commercially innovative Capital Markets, the intentions, interpretations and policies of FSA are the natural benchmark against which the industry seeks to operate and comply. Any other standard is even more difficult to discern, albeit that FSA's can be understood only through its historical articulation and not always in the most transparent manner.

It is for these reasons that this Book explains each rule or rule set (1) in its functional social context and by reference to (2) its original policy formulation and (3) its drafting within the then (a) legal infrastructure and (b) regulatory system and environment, (4) all as developed up to the

[15] *Marleasing*, Case C-108/89, [1990] ECR 1–4135, para. 8.
[16] *Understanding Common Law Legislation*, F. Bennion, Oxford, 2001, p. 153.
[17] *Henn and Darby* v. *DPP* [1981] AC 850 at 905.
[18] *Understanding Common Law Legislation*, Bennion, p. 155.
[19] *James Buchanon & Co. Ltd.* v. *Babco* [1977] 2 WLR 107 at 112.
[20] Principles based regulation, FSA, April 2007, p. 17.

present. It does this using the rule itself, such other formal material as may appear within the rulebook, and any extraneous material (discussion documents, consultation documents, policy documents, regulator comments and speeches, previous rules etc. etc.), whether or not contemporaneous with the original rule or the present rule, as may be considered relevant to the understanding of that present rule. (For this reason the reader should use this Book together with an up-to-date version of the rules.) It is necessary to construct such a patchwork because the regulator often does not provide an up-to-date articulation of the meaning and to the extent that this Book is incorrect on any particular point and that stimulates FSA to issue a different view then its purpose has been achieved.

As a matter of style, where possible the Book quotes the original source, rather than the author's summary or restatement, 'as a basis for comment, criticism or review'.[21] Further, because of their sociological/economic roots, the rules tend to have a large number of interconnections so that cross-references to other Chapters are contained in brackets at the end of a sentence, for example, '(4.2(g), 12.5, 13.2.1)'. This avoids having to restate a particular point or argument and the reader should always consider the referenced Chapter/paragraph in relation to the current point. The logic of the rule (or lack of logic) is also expressed through matrices and flowcharts in the Figures, with a textural explanation following the 'picture'.

Having said all of this, it will be clear that, for the author, law is not a search for the truth. That is the province of the physical sciences. Law, as a social science, is all about understanding and assisting people in their social relations. It may also be, in a book such as this, about challenging and stimulating the reader's understanding and, to that extent, a dose of theatre.

> People nowadays think that scientists exist to instruct them, poets, musicians etc. to give them pleasure. The idea that these have something to teach them – that does not occur to them.[22]

Accordingly, the views expressed remain solely the author's and are not be attributed to any organisation with which he is associated except to the extent that it agrees with them.

[21] *Hubbard* v. *Vosper* [1972] 2 QB 84 at 95.
[22] *Culture and Value*, Ludwig Wittgenstein, Blackwell, 1977, p. 36c.

2
FSMA and the single market

2.1 Evolution

When analysed historically, any area of UK financial services regulation resolves itself into seven phases of development, each of which needs to be understood for a complete understanding of contemporary regulation and, in this Chapter, is illustrated by reference to the capital markets:[1]

I. A series of ad hoc and, at first sight, random and unconnected rules formulated as a response to individual and particular social and economic problems. In the regulation of the capital markets this phase lasted up to the 1930s. See 2.2.

II. 'Institutional regulation' of a particular type of firm, conducting a particular type of business, in the form of required registration of that firm with a government body, supported by limited conduct and/or prudential rules of the type found in Phase I. Complete institutional regulation subjects the firm to regulation of all its activities, whether or not within the description that requires registration in the first place, although in this Phase, which lasted up to the 1980s in the Capital Markets, the imposed regulation was piecemeal and, once registered, the firm was regulated in only limited aspects of its activities. See 2.3.

III. 'Functional regulation' of a particular type of activity, irrespective of the nature of the firm carrying it on, through licensing by a Government Department and/or self-regulatory body (itself under statutory supervision), supported by rules governing the activities as a whole of the firm. This Phase, represented by the 1986 FSAct, lasted for 15 years up to the early 2000s. See 2.4.

[1] These Phases, it must be reemphasised, are not stages in regulatory development towards some form of perfection. They are merely convenient categories for analysis and explanation. The reality is that 'We cannot predict, by rational or scientific methods, the future growth of our scientific knowledge . . . We cannot, therefore, predict the future course of human history. This means that we must reject the possibility of . . . a historical social science that would correspond to theoretical physics. There can be no scientific theory of historical development serving as a basis for historical predictions' (*The Poverty of Historicism*, Karl Popper, Routledge, 1989, pp. (vi)–(vii). See also, Theses on the Philosophy of History, in *Illuminations*, Walter Benjamin, Pimlico, 1999, pp. 245–255).

IV. Licensing of particular types of activity, i.e. 'functional regulation', by a single Government regulator, supported by rules governing the activities as a whole of the firm. This is the FSMA regime. See 2.5.

V. Parallel to Phases III and IV, at a supra-national level, groups of domestic regulators, including UK regulators, set, initially, basic standards and, subsequently, detailed standards for particular activities to be adopted by domestic regulators. Such standards, set by the Bank for International Settlements (BIS)/Basel, for banks and, more recently, regulatory capital standards generally for banks and investment firms, and the International Organisation of Securities Commissions (IOSCO), for investment firms, have by-and-large found their way into, and influenced to some extent, the content of the UK regulation of the Capital Markets, although their separate content is beyond the scope of this book.

VI. From the 1970s (for the UK) the European Union trading block of sovereign States has increasingly moved towards a Single Market in financial services by adopting standards to be implemented by the sovereign States, including the UK. See 2.6.

VII. The future? The Lamfalussy methodology (2.6) seems relatively unlikely to achieve harmonisation of rules and operating procedures across the EEA[2] and, if it fails, the only long term solution will be a single central EU regulator for financial services, with local Member State regulators implementing and enforcing the rules and policies made by the central regulator. This will be something like the European Central Bank model. The question is whether the FSA will be that central regulator?

2.2 Up to the 1930s

2.2.1 The Secondary Market and The London Stock Exchange

The absence of coherent securities regulation is illustrated by the way that in 1909 the London Stock Exchange, being the only real place where company and government securities were dealt in, made a rule forcing members to choose to be either a broker (acting as agent on behalf of its client) or a 'jobber' (acting as market maker, having no direct contact with clients and dealing only with brokers). This 'single capacity', however, was introduced purely to preserve the business interests of Stock Exchange members,[3] albeit that it had the legal effect of managing conflicts of interest

[2] For the sheer complexity of the operation of the methodology, see Second Interim Report Monitoring the Lamfalussy Process, Inter-Institutional Monitoring Group, Brussels, 26 January 2007.

[3] *The London Stock Exchange: A History*, R. Michie, Oxford, 1999, p. 113.

in that the broker, acting as agent, owed its client fiduciary duties and could not deal with him as principal, selling his own property and making a secret profit; whereas the jobber, acting as a principal, had no direct contact with the client and, thus, owed no fiduciary duties which prevented such profit.[4]

2.2.2 Primary market new issues

As regards the Primary Markets, being new issues of securities, promoters of companies emerged and were sustained in the late 19th and early 20th centuries because of the unwillingness of merchant banks to sponsor corporate securities issues. Their worst excesses, being the promotion of fraudulent or over-optimistic schemes and the taking of enormous profits out of the monies raised, always without complete disclosure to investors, were stopped by a series of Companies Acts enforcing disclosure in the prospectus. First, in the mid 1840s, the practice of appointing stooge aristocratic directors to the board of the company was stopped by imposing a statutory penalty if the prospectus 'falsely pretend[ed the company] to be . . . directed . . . by eminent or opulent Persons' (1844 CA LXV). Then, a decade later, it was made a criminal offence to 'make, circulate or publish . . . any written statement . . . which he shall know to be false in any material Particular with intent to . . . induce any Person to become a Shareholder' (1857 Fraud Act VIII). At common law a damages claim lay for a fraudulent prospectus[5] and rescission for innocent misrepresentation,[6] but a negligence claim was introduced only in 1890:

> When . . . a prospectus . . . invites persons to subscribe for shares . . . or debentures . . . every . . . director . . . and every promoter of the company . . . shall be liable to pay compensation to all persons who shall subscribe . . . on the faith of such prospectus . . . for the loss . . . they may have sustained by reason of any untrue statement in the prospectus . . . unless . . . he had reasonable grounds to believe . . . that a statement was true. (1890 Act to amend the law relating to the Liability of Directors and Others for Statements in Prospectuses 3(1)).[7]

A claim for negligent misstatements in the prospectus against the company was possible after *Donohue* v. *Stevenson*[8] but (and this neatly illustrates the limits of investor protection in Phase I), given the partnership origins of the joint stock company, legal logic allowed the claim only if

[4] *Bentley* v. *Craven* (1853) 18 Beav. 74 at 76–77; *Aberdeen Rail Co*. v. *Blaikie Brothers* 1854 in [1843–60] AER 249 at 252 (6.2.2.3). [5] *Derry* v. *Peek* (1889) 14 App. Cas 237.
[6] *Oakes* v. *Turquand* (1867) LR 2 HL 325.
[7] This provision was substantially re-enacted in 1908 CA 84(1), 1929 CA 37 (1), 1948 CA 43 (1) and 1985 CA 67. [8] [1932] AC 562.