

**Memorandum by the City of London Law Society Regulatory Committee on
HM Treasury's consultation: "Financial Services and Markets Act two year review:
Changes to secondary legislation"**

The City of London Law Society Regulatory Committee comprises lawyers whose principal practice area is in the financial services and markets field. Its members are therefore concerned, on a daily basis, with advising clients on many different aspects of the regulatory regime. The comments which we make are therefore based on a considerable amount of experience of the interpretation and application of the financial services legislation. For ease of reference this memorandum follows the headings in the Consultation Paper.

Overview

We welcome HM Treasury's two year review as it deals with a number of issues that we have raised in the past. Our detailed comments on the proposals are set out below.

We do however have a concern that there are a number of significant issues which are not addressed in the two year review, which continue to cause real day to day difficulties for both authorised and unauthorised firms and their advisers. We would urge HM Treasury to address these issues now, rather than in due course. We have in mind in particular:

1. The scope of the financial promotion regime. There remain significant uncertainties about the true meaning and scope of the financial promotion prohibition and we do not regard the guidance issued by the FSA as a complete solution to the issues raised. We, as City lawyers, deal on a day to day basis with this regime, yet even we have difficulties in being certain as to its scope and interpretation in a range of situations. However, many situations which potentially fall within the financial promotion regime will not even be considered by firms such as those represented on the City of London Law Society Regulatory Committee. We think there is a real risk that the regime is being ignored in practice (in part through ignorance and in part through confusion as to its scope). At a practical level, given its complexity, we do not think that advisers who are not specialist in the area could even be expected to grasp the full potential impact of the regime. It is not healthy or helpful for such an important law, breach of which has important consequences for civil law obligations as well as criminal consequences, to be both so uncertain and potentially so broad.

Therefore, we would in particular welcome the regime becoming more focussed so that it is targeted at the protection of individuals who are not acting in the course of a business, trade or profession. At present the regime impacts on transactions and dealings between businesses, raising unnecessary difficulties and costs in an arena where no protection is needed which is additional to that provided by the general law (for example in relation to innocent, negligent and fraudulent misrepresentation, breach of contract, fraud etc.). The fact that the regime is considerably wider than that in other Member States raises particular difficulties in relation to implementing provisions for the E-Commerce Directive.

We would welcome the opportunity to present to HM Treasury suggestions for a simplification and clarification of the regime, designed to achieve this end.

2. We also have a real and continuing concern about the provisions relating to controllers - these provisions are, we believe, more extensive than is required by the relevant Directives, and compliance with them is a real cost in terms of both time and money for the firms affected by them, with no corresponding investor protection or other benefit.

We consider that both of these issues should be dealt with in this review and not delayed until some future indeterminate date.

The Impact of FSMA on Advice Centres

Q3 Is there a case for further legislation?

Q4: Do you think that there should be additional legislation to confirm that advice centres are not carrying on regulated activities?

We consider that creating a specific exemption for advice centres in relation to the business test might cast unnecessary doubt on whether other organisations, currently relying on the business test, can continue to do so safely. The business test gives rise to a number of borderline issues in a variety of situations and advice centres should not receive special treatment in relation to the business test. If there is to be further legislation we believe it should be in the form of an exemption from the activity of providing investment advice and arranging, subject to such conditions as HM Treasury thinks appropriate. This would mean that some advice centres could continue to take the view that they are not acting in the course of business, the additional exemption would provide comfort for those who consider that this option is not available due to the way in which their activities are structured.

Employers offering pension products

The issues identified by HM Treasury in this area do cause real difficulties to employers.

Q10: Do you agree that there should be an exemption for both real time and non-real time promotions made by employers?

We agree that there should be an exemption for both real time and non-real time promotions made by employers.

Q11: Do you agree that any exemption should be subject to conditions and not be unrestricted?

Whilst it may be appropriate to impose some conditions, conditions relating to financial contributions and financial benefit to the employer may not be appropriate. We consider that, provided that the type of investment is limited and that employees are informed of their right to seek independent advice, this would be sufficient to protect employees without imposing unnecessary conditions on employers. If HM Treasury has a concern about benefits received by the employer, there could be a requirement that any benefit has to be disclosed in writing to employees who receive the promotion.

Q14: Do you think that the exemption should contain an additional condition restricting the ability of employers to provide individual advice to employees?

Q15: If so do you think that limiting the ability of employers to make promotions by a requirement that they do not provide pensions advice in relation to an employee's individual circumstances is an appropriate condition?

Q16: Do you think that limiting the ability of employers to make promotions by reference to the definition of the activity of advising in article 53 RAO is an appropriate condition above?

Q17: Do you think that limiting the ability of employers to make promotions by prohibiting reference to unfavourable comparisons with other pensions is a viable alternative condition above?

As far as advice by employers is concerned, it is important that employers are clear as to what they can and cannot do. It is essential that there is no risk that they are permitted to make a financial promotion but then run the risk of giving investment advice in a way which requires authorisation. An alternative approach to those suggested by HM Treasury would be to require employers to make it clear to their employees that they are not authorised to give investment advice - linking this to giving employees information as to their right to seek independent advice.

Q18: Do you agree that there should be no restriction on which employer’s representatives can promote the employer’s pension schemes?

We agree that there should be no restriction on which employer’s representatives can promote the employer’s pension schemes.

The Financial Promotion Order

Q19: Do you agree with the proposed changes to the Financial Promotion Order?

“Issued by” references

We agree with this proposed amendment.

“Made to” and “directed at”

We welcome the proposed widening of the exemption in article 43.

“By or on behalf of”

We welcome the extension to article 43.

We suggest that the amendment proposed in paragraph 5.6 should be incorporated as a general principle throughout the Financial Promotion Order. There is no logical reason in allowing some communications to be made by or on behalf of a person whilst requiring that others must be made by a particular person.

As far as article 14 is concerned we think that the additional qualification that the person who made the first communication is responsible for any further communications, raises ambiguities as to what is meant by “is responsible for”. We would suggest that instead the subsequent communicator should draw attention to the fact that the communication is made on behalf of a third party and draw attention to the rubric/warnings already given.

Article 11 – combination of different exemptions

We welcome the proposed relaxation. However, we wish to draw HM Treasury’s attention to the fact that some issues still remain when seeking to combine exemptions. This can occur when seeking to combine exemptions when at least one of them contains the word “only” - for example article 43 applies to certain communications by a body corporate “which relate only to a relevant investment which is issued or to be issued...”. The question therefore arises as to whether this exemption can be relied on in conjunction with, say, article 70 which

provides an exemption for communications to which listing rules apply. Could a promotion which combined a promotion within article 70 be distributed in the same document as one in which the sender seeks to rely on article 43?

We think that there should be a general interpretation provision similar to that in article 19(6) so that the use of the word “only” in any particular exemption does not hinder the combining of exemptions. There would appear to be no investor protection reason to avoid such a conclusion - the communicator would have to be satisfied that each element of the financial promotion and each recipient fell within one or more different exemptions.

Articles 15 (introductions), 18 (mere conduits) and 51 (associations of high net worth or sophisticated investors)

We welcome the proposals in relation to articles 18 and 51.

As far as article 18 is concerned, we would have thought the clarification is unnecessary. It also highlights the continuing difficulty with the financial promotion regime and the exemptions - namely their application when one person causes a communication which is made by another person. Difficulties arise in particular where an unauthorised person causes an authorised person to make a promotion - for example, where a company causes its corporate finance adviser to issue a promotion. We consider that it ought to be made clear that if a promotion is communicated by an authorised person, then there ought not to be an additional requirement that the authorised person expressly approves the promotion. This gives rise to an additional expense (the authorised person will generally charge a not insignificant fee for doing so) and, depending on the circumstances, there can be scope for argument as to whether a particular communication made by an authorised person should be regarded as having been “caused” by another. If HM Treasury has a particular concern about implementing this principle, we believe it would be better to address the particular concern, rather than avoid dealing with the issue generally.

Article 55a - communications by members of the professions

We think that the proposed amendment risks casting doubt on rubrics required by other exemptions, should they contain typographical errors. It would be better if all of the requirements in the Financial Promotion Order for particular wording were rephrased to require communicators to follow “substantially” the relevant requirements.

Q20: Are there any further changes to the Financial Promotion Order which you think should be considered?

We have indicated above that we think that there are further changes to the Financial Promotion Order which we think should be considered and we would welcome a discussion with HM Treasury on these issues.

Article 69 - promotion of securities already admitted to certain markets

Q21: Do you agree that the current article 69 of the Financial Promotion Order is too complex and should if possible be simplified?

We agree that the current article is too complex and should be simplified.

Sale of a body corporate

As a practical matter this is probably one of the most used exemptions in the entire Financial Promotion Order and, given the breadth of the financial promotion regime, has been necessary to avoid the expense, cost and complication which would otherwise arise on sales of companies.

A key motivation of HM Treasury in suggesting the change would seem to be that the exclusion reduces the statutory underpinning of the Takeover Code. In paragraph 6.19, HM Treasury suggests that it has rejected an approach which sets the threshold at the point where a transaction is subject to the Takeover Code, on the ground that the scope of the Takeover Code may not be clear enough to set the boundary of regulation. We would not agree with this view of the Takeover Code, and indeed if there is any doubt this could always be resolved by consulting the Takeover Panel. There are many concepts (of which financial promotion itself is one) which are not necessarily very clear when it comes to understanding the boundary of regulation.

Our strong preference would therefore be for the exclusion to remain as drafted, save for an amendment to make it clear that it does not apply to transactions subject to the Takeover Code.

Apart from the issue concerning transactions subject to the Takeover Code, we are not now clear as to where the Treasury thinks the boundary of the exclusion should end, or why it should end at any particular juncture. We have the following particular comments on the draft wording in article 69.

The proposed changes to the article make it extremely complex - given that this article is one that is mostly likely to be used in transactions around the country, there needs to be no doubt or complexity in relation to its drafting and application. The complexity arises because of the introduction of two different exemptions for different transactions each containing limitations

as to the persons involved. Conditions which require analysis of the nature of and relationship between the persons involved in a transaction produce complexity and often uncertainty. In addition, they are likely to mean that many transactions will fall outside their scope. Many companies, originally held by closely-related family members, develop over time a more widespread shareholder base as a result of marriage, divorce, employee incentives etc. There is no valid investor protection reason for the nature of the change suggested. We are not aware of any case where the application of the current exemption has led to difficulties for investors.

We suggest that if HM Treasury really is concerned about the position of some “miscellaneous” shareholders, a more proportionate solution would be to require financial promotions which are made in reliance on an exemption for sale of a body corporate, to say so and to state that if the person requires advice on the investment merits of the transaction he should take it from an independent adviser.

The concepts of groups of connected individuals always gives rise to difficulties - in many situations it will be found that there will be one person who holds or is to hold securities for a good reason, but who is not within one of the categories, thus giving rise to additional cost and complexity for the transaction as a whole. The concept of “persons acting together” is also vague - what is required for persons to be regarded as so acting?

Article 69(2) represents a change to the current position and a complication. It would seem that S must hold or dispose of 50% or more of the voting shares. We think that the trigger for the change should be that, as a result of the transaction S will hold more than 50% or will hold less than 50% - a requirement that he disposes of a full 50% of the voting shares would (probably unintentionally) exclude transactions where S disposes of less than 50%, but as a result of the disposal, then holds less than 50% of the company.

We are also concerned by the narrowing of the current article. We understand HM Treasury’s view in relation to advice. However, there are many transactions where advice is not given to an individual shareholder, but the arrangements which are made for the sale of the company are arrangements in which he participates (assuming that he has decided to sell).

We think that the exclusion for making arrangements should be broader and we do not see any particular investor protection issue here. As presently drafted there must be a real concern that any transactions which involve the sale of the entire share capital of a body corporate will only be partially exempt - which will lead to added complications and expense caused by what may be a very small shareholding in the company.

As far as the definition of a small company is concerned, we would have a preference for option 2, but note that the concept of ownership by “no more than 50 persons” will itself give rise to the same kind of issues which arise under the Public Offer of Securities Regulations. For example, where a nominee owns shares, or a trustee owns shares - to what extent does one take into account any beneficial owners (who may or may not be identifiable)? It is important that the concept of “relevant unlisted company” is not used - there are many companies which have not existed for 10 years - if the concept is therefore used, it must be clear that the requirement relating to 10 years can be taken to refer to such lesser period, if appropriate, that has expired since the company’s incorporation.

Our responses to your questions 24-31

Given our position as stated above we respond to the specific questions as follows:-

Q24: Do you agree that the exclusion in the Regulated Activities Order should be narrowed so that the “may reasonably be regarded” test will apply only in relation to a party who is acquiring or disposing of the day to day control of that body corporate and hence not to advice given to a party whose object is not acquisition or disposal of day to day control?

No. We consider that the exemption should continue to be based upon the **transaction**, rather than the parties involved in it.

Q25: Do you agree that the exclusion in the Regulated Activities Order should be narrowed so that the “may reasonably be regarded” test will apply only in relation to takeovers of small companies?

Yes.

Q26: Which option do you prefer as the definition of “small” company in respect of which the “may reasonably be regarded” test should apply?

Option 2.

Q27: Do you agree that the exemption for promotions in respect of takeovers should be subject to the same conditions as those which apply under the revised RAO?

No. We do not think that the reasons for restricting the regulated activity exemption should automatically cross-apply to a mere financial promotion.

Telephone campaigns

Q28: Do you agree that it is desirable to have some form of regulation or conditions on unauthorised persons who are carrying out telephone campaigns?

Yes

Q29: Do you agree that broadly speaking we should regulate to the same extent as under previous legislation?

We welcome the concept that an authorised person could approve the script and pre-approved answers for a telephone campaign, but note that the FSA rules do not currently permit approval of real time financial promotions.

Q30: Which of the three options do you prefer and why?

Option 3 because it mirrors the Takeover Code provisions.

Q31: Do you agree that under the proposed regulatory framework the provisions in the Financial Promotion Order providing exemptions for takeovers of relevant unlisted companies (i.e. Articles 63-66) are no longer necessary?

Articles 63 to 66 may be rarely used, but we see no reason why they should be revoked and urge HM Treasury to keep them. Particularly given the narrowing of the sale of the body corporate exclusion, they may be used more frequently in future.

Investment by occupational pension scheme trustees

Q32-37

We welcome and agree with all of the changes proposed by HM Treasury in this regard.

Changes to the Regulated Activities Order

Theatrical Debentures

Q38: What are your views on the three changes proposed to the Regulated Activities Order? We seek, in particular, views on the question of theatrical debentures.

In our view it would be better if the legislation is left as currently drafted. We appreciate that HM Treasury is trying to address an issue which has been raised with it, but we believe that the proposed amendment may have unintended consequences. If the Treasury nevertheless

proceed with the amendment we believe that the words “actual or contingent” need to be inserted after the proposed words “a present or future”, in the new provision.