New court decision widens the potential liability of principals for their appointed representatives

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The recent Court of Appeal decision in KVB Consultants Ltd and others v Jacob Hopkins McKenzie Ltd and others [2024] EWCA Civ 765 (9 July 2024) has important implications for any regulated firm that acts as principal to an appointed representative (AR). The principal under an AR arrangement now appears to be responsible for a wider range of activities than it might have anticipated – including potentially in respect of activities that it has expressly prohibited its AR from undertaking and/or that it may not legally be able to do itself. This decision potentially increases the risk exposure of principals in relation to the activities of their ARs.

Background

Under the Financial Services and Markets Act 2000 (FSMA) no person may carry on a “regulated activity” in the UK unless they are either authorised by the FCA or an exempt person. Breach of this rule, which is known as the general prohibition, is a criminal offence and any transactions entered into as a consequence of such a breach are potentially unenforceable.

Section 39 of the FSMA contains a mechanism under which a person who is not authorised by the FCA can become an exempt person and thus can perform certain regulated activities. If that person (who is known as an “appointed representative” or “AR”):

- enters into a contract with someone who is authorised by the FCA (his “principal”), which complies with certain prescribed requirements; and
- is someone for whose activities in carrying on the whole or part of that business his principal has accepted responsibility in writing

that person is exempt from the need for FCA authorisation in relation to “*any regulated activity comprised in the carrying on of that business for which the principal has accepted responsibility*”.

AR arrangements are a relatively straightforward way for non-authorised persons to be able to carry out regulated activities. They are commonly used within groups of companies so that an authorised person in the group can support a non-authorised affiliate in carrying on regulated activities without the affiliate

needing to apply for a separate licence. There are also principals who offer a service under which they appoint third parties as their ARs in return for a fee.

There are, however, legal limitations on what an AR can do. Under the FSMA regime, only certain specific types of regulated activity can be covered by an AR arrangement – the main ones being “advising on investments”, “arranging deals in investments” (e.g. acting as an intermediary to help bring about a transaction between two other parties), dealing as agent (but only in relation to certain types of insurance contract) and entering into various types of consumer lending agreement and/or providing certain debt-related services. An AR cannot be appointed to carry on regulated activities that are not listed in the relevant regulations (such as “managing investments” or operating collective investment schemes).

In addition, the FCA rules state that the principal can only appoint an AR to do regulated activities that fall within the scope of the principal’s own FCA permission. If, for example, a principal did not have permission from the FCA to carry on the regulated activity of advising on investments, it could not appoint an AR to carry on that activity.

The facts

In the recent case of *KVB Consultants Ltd and others v Jacob Hopkins McKenzie Ltd and others* [2024] EWCA Civ 765 (9 July 2024), Kession Capital Limited (KCL) was an authorised person that – acting as principal - entered into a contract to appoint Jacob Hopkins Mackenzie Limited (JHML) as its AR.

Under the terms of the AR contract:

- JHML was appointed to carry on the regulated activities of “advising on investments” and “arranging deals in investments”.
- There was an express provision that the AR was “*not permitted to conduct any business with retail clients*”. This reflected the fact that KCL did not have permission from the FCA to do the “advising” activity for retail clients (although it did have permission to “arrange deals” for retail clients).
- There was an express prohibition on the AR operating a collective investment scheme.

Notwithstanding these restrictions, JHML carried out a much broader range of activities than was permitted under the AR contract. JHML operated a series of property investment schemes, which the court found amounted to collective investment schemes. JHML also promoted these schemes to retail clients, who invested approximately £1.7m into them.

The property schemes operated by JHML failed, and the investors lost their money. The investors sought to recover their losses from KCL, as the principal of JHML.

The decision at first instance

At first instance, the court found in favour of the investors. The judge found that the AR’s activity of “operating” the property schemes had been unlawful and was not covered by the AR contract. However, as the AR contract anticipated that the AR could “arrange deals” and “advise” on schemes of this nature,

the activities of the AR in soliciting customers were within the scope of the AR arrangement – and so the principal could be liable for losses suffered as a result of those activities.

On the question of why the principal should be liable for the AR selling investments to retail clients when the AR contract contained a provision expressly prohibiting business with retail clients, the judge said that that provision did not define "what" activities the AR could do – i.e. what regulated activities that the AR could carry on because the principal had accepted responsibility for them under the mechanism in section 39 of the FSMA. Instead, he said that restriction only defined "how" the AR went about doing the activities.

On that basis, although JHML's actions in marketing the schemes to retail clients were in breach of the AR contract, those actions were within the scope of the authority given to the AR under the AR contract to carry on regulated activities – and KCL was therefore liable in respect of them.

KCL appealed that decision to the Court of Appeal.

Court of Appeal decision

The Court of Appeal, by a 2:1 majority, rejected the appeal and decided that KCL was responsible for the losses suffered by JHML's customers.

The majority in the Court found that the prohibition in the AR contract on doing business with retail clients operated as a contractual term between the principal and the AR, and did not affect the scope of the permission given by the principal for the purposes of section 39 of the FSMA. The court endorsed the view from the court of first instance that this was a question of "how" the AR could perform activities, not "what" activities it was permitted to perform.

On the question of KCL being liable for an activity that it did not have permission to do (i.e. advising retail clients), the majority found that that did not affect the interpretation of section 39. Instead, they said that the onus would be on the principal to supervise the activities and systems of its AR and that liability could follow for the principal if the AR did not comply with the terms of the AR contract.

The dissenting judge, Lord Justice Lewison, disagreed in relation to the retail client issue. He noted that since the FCA was empowered to grant permission for such of the regulated activities as may be specified in the permission (describing them), and had done so in relation to advising on investments, he would regard the exclusion of retail clients as falling on the "what" rather than the "how" side of the line. On that view, since the FCA permission given to KCL did not extend to advising retail clients, KCL would not be an "authorised person" as regards advising retail clients on investments and so could not appoint the AR to do that activity.

Analysis

This may be a case where the Court was influenced by a desire to ensure that the investors in the schemes were not left without legal recourse. If KCL was not responsible for the AR's actions, the retail investors would have had to sue the AR - which, as the Court noted, was insolvent. If a regulated entity like KCL was liable, however, compensation would be available – either from KCL's own resources, or through any professional indemnity cover that KCL had or (if KCL itself were to become insolvent) from

the Financial Services Compensation Scheme. The decision of the majority in the Court of Appeal thus enabled compensation to be paid.

However, the minority view in the Court seems more consistent with the way that FCA permissions operate. When the FCA grants a permission to do an activity, it always specifies what category of client that activity can be done in relation to. To ignore that part of the FCA permission when determining what the AR can be authorised to do seems difficult to justify.

The fact that the Court has done this creates a precedent that is unlikely to be welcome to most principals.

This decision means that principals in AR arrangements could be liable for activities undertaken by ARs that they do not themselves have permission to do. Principals cannot assume that, even if an AR acts in breach of the AR contract, the principal will not be liable.

In practice, this means that principals will need to supervise their ARs even more closely than they do currently. In particular, they should consider seeking evidence of all of the AR's activities, not merely those that are contemplated under the AR agreement.

The decision gives rise to a particular concern for AR arrangements which are only intended to apply to services for professional clients rather than retail clients. There is now a clear precedent that the principal will be liable if a rogue AR starts dealing with retail clients as well.

The FCA has not made any public statement regarding the decision of the Court of Appeal. Even if the FCA disagreed with the decision, the question relates to the interpretation of legislation and the views of the court will take precedence over the views of the FCA. Unless the decision is appealed, or another similar case comes to the Court of Appeal, the precedent established by this case may be around for some time.

Next steps

Firms which have ARs should consider the implications of this case for their AR relationships. They should consider, in particular, what additional supervisory efforts may be required in order to mitigate the risk of the AR doing something outside the scope of the AR contract that the principal could still be liable for.

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