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THE REGULATION OF DEPOSIT-TAKING BUSINESS

Introduction

1.01 The conduct of banking business is regulated in a variety of ways. At the most basic level, some form of licence or authorization will always be required before an entity can engage in banking at all.[1] Thereafter, of course, there will be ongoing requirements as to competence of management, adequacy of capital, conduct of business and other matters. In a modern economy in which banking plays such a key role, the existence of these requirements needs no philosophical justification. Indeed, the depth of the financial crisis which gripped the world in the period beginning in 2008 means that political pressure for further regulation of banks and financial institutions will only intensify.[2]

1.02 Yet matters are more complex than these broad statements may immediately suggest. For example, banking is now an undeniably international business, and the insolvency of an institution will invariably have repercussions beyond its own national boundaries.[3] Yet the framework put in place for banking supervision is in many ways dependent upon purely national, legal structures. One only has to state this proposition to realize that there is in many ways a serious mismatch between the essentially territorial scope of the regulator's powers and the international reach of many banks. Efforts are periodically made—and

[1] Although, as will be seen, the mere activity of lending one's own capital to commercial customers (as opposed to consumers) does not require any form of authorization in the United Kingdom.

[2] Some of these developments are considered in Chapter 8 below.

[3] Again, this statement requires no justification but the aspects of the crisis relating to certain Icelandic banks provide an obvious illustration: see the discussion at para 13.13 below.

are currently being made—to bridge this gap. Inevitably, however, domestic political considerations may render this process difficult.

1.03 With these factors in mind, it is proposed to examine the following matters:

(a) the history of the regulation of banking business in the United Kingdom;
(b) deposit-taking as a regulated activity;
(c) the authorization procedure;
(d) the powers of the Financial Services Authority (FSA); and
(e) finally, brief mention will be made of the position of banks incorporated in other parts of the European Economic Area (EEA) but carrying on business or providing services within the United Kingdom.

The History of Banking Regulation in the United Kingdom

Introduction

1.04 Until 1979, there was no domestic legislation that regulated the conduct of banking business in the United Kingdom. Indeed, insofar as banking business comprises the making of loans and advances to customers, the absence of regulation remains a significant feature of the current legislation.[4] Until 1979, the Bank of England operated an informal system of supervision which relied upon an expectation of compliance and the general influence of the central bank in the financial sphere.[5] At that point, however, Parliament passed the Banking Act 1979, which required that the acceptance of deposits from the public should be subject to prior authorization by the Bank of England. The Act was passed in order to give effect to this country's obligations under the First EC Banking Directive, which required a formalized system of authorization and supervision for the banking sector.[6] The regulatory framework was subsequently revised and extended by the Banking Act 1987. The main consequences of the 1987 Act were (i) a streamlining of the authorization process,[7] (ii) the introduction of a 'large exposures' reporting system,[8] and (iii) the Bank of

[4] The exceptions to this statement relate principally to mortgage lending and consumer credit, where regulation seeks to compensate for a lack of bargaining power. These aspects will be discussed at paras 4.02–4.54 below. The perhaps somewhat anomalous position stated in the text is in some respects mitigated by the fact that, again subject to exceptions, a person cannot accept a loan (or deposit) from an institution which does not hold an appropriate authorization or whose business does not consist mainly of money lending (see the discussion at para 1.14 below). It should be added that, whilst a bank's lending activities are not *directly* regulated, they are indirectly regulated by a number of means, eg through the rules requiring an institution to hold sufficient capital to meet its risks, rules governing large exposures and similar measures: see generally the discussion in Chapter 6 below.

[5] The history of banking supervision in the United Kingdom is briefly described in the opening remarks of Lord Steyn in *Three Rivers DC v Bank of England* [2001] 2 All ER 513 (HL).

[6] The scope and effect of the First Banking Directive was one of the issues which arose for debate in the *Three Rivers* litigation, and is accordingly discussed in Chapter 14 below.

[7] An institution which wished to accept deposits would henceforth have to be an 'authorized institution'. This replaced the earlier system under the 1979 Act, which provided for a two-tier structure of 'recognized banks' and 'licensed deposit takers'.

[8] On this subject, see paras 6.63–6.68 below.

England was given more 'teeth' in the sense that it had greater powers to demand information and to carry out investigations.

1.05 A notable feature of the 1987 Act—especially when compared with the current legislation—is that the Act regulated *who* could carry on a deposit-taking business but, subject to minor exceptions—it did not regulate *how* that business should be carried on, in the sense that there were very limited rules dealing with the conduct of business.

1.06 It was at this point of time that the incoming tide of European legislation began to become more evident. In 1989, the EC Council adopted its Second Council Directive on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions,[9] which was implemented in the United Kingdom by means of the Banking Coordination (Second Council Directive) Regulations 1992.[10] These regulations gave effect to the Community's 'passporting' scheme, under which it would no longer be necessary for an EC-based institution to be separately authorized in each of the EC Member States in which it had a branch or provided services. Instead, it would be permitted to establish a branch and undertake local activities in those other countries in reliance on its home State authorization. Although these particular regulations have now been repealed, the passporting system remains in effect through later directives and their implementing regulations, and this forms one of the key pillars of EU banking law.[11] In addition, the Community began to introduce further directives intended to implement the capital adequacy and other prudential requirements laid down by the 1988 Capital Accord published by the Basel Committee on Banking Supervision (Basel I).[12] The further initiatives included the Own Funds Directive,[13] the Solvency Ratio Directive[14] and two directives dealing with capital adequacy issues.[15] All of these directives have subsequently been consolidated and amended in the light of further recommendations by the Basel Committee in the field of capital adequacy.[16] So it will be seen that the early 1990s saw a significant 'Europeanization' of banking law, mainly as a harmonizing measure with a view to completing the EC's 'single market'.[17]

1.07 More recently, however—and in a move which was not dictated by considerations of Community law—the government determined that the functions of the central bank

[9] 89/646/EC, OJ L 386, 30.12.1989.

[10] SI 1992/3218.

[11] For further discussion of this subject, see paras 2.13–2.17 below.

[12] The Basel Committee on Banking Supervision was originally established in 1974. It consisted of the governors of the central banks of the G10 States, but its membership has recently been expanded. It has no treaty or other formal, legal basis, but its recommendations have tended to be adopted as minimum standards for banks which are active in international business.

[13] 89/229/EEC, OJ L 124, 5.5.1989, p 16.

[14] 89/647/EEC, OJ L 386, 30.12.1989, p 14.

[15] 93/6/EEC, OJ L 141, 11.06.1993, p 1 and 98/31EC, OJ L 204, 21.7.1998, p 13.

[16] The later (and current) structure is known as 'Basel II'. On this subject, see generally Chapter 6 below.

[17] The whole subject of EU banking law is considered in more depth in Chapter 2 below. The same 'Europeanization' has also been apparent in the field of investment services: see in particular the Markets in Financial Instruments Directive which, so far as relevant to banks, is considered at paras 3.26–3.52 below.

should be separated from those of the market regulator,[18] and the task of banking supervision was transferred to the FSA.[19] The decision to transfer banking supervisory functions to the FSA was not, however, a 'stand alone' decision. It formed part of a larger plan to provide for unified supervision of the financial markets as a whole by a single regulator. Given the interdependence of the different segments of the financial markets (banking, insurance, fund management, and other businesses) it was argued that this was an appropriate step, although the wisdom of removing bank supervision from the Bank of England has been questioned by some commentators in the wake of the recent financial crisis.

1.08 The final legislative result of this decision was the Financial Services and Markets Act 2000 (FSMA), most of which came into force on 1 November 2001. It has been pointed out elsewhere[20] that the 2000 Act succeeded in being both a formidable, and yet at the same time inchoate, piece of legislation. It is formidable in the sense that it runs to some 433 sections and 22 schedules; yet it is inchoate in the sense that the Act itself answers few of the practical questions to which the scheme of regulation gives rise on a daily basis. Instead, it confers upon the FSA a broad rule-making power, and it will almost invariably be necessary to refer to those rules in order meaningfully to deal with any issues that may arise. As noted earlier, the legislation deals not merely with banking but also with other aspects of the financial markets. The present discussion will, however, naturally concentrate on issues relevant to the conduct of banking and associated business.

Deposit-Taking as a Regulated Activity

Introduction

1.09 Perhaps the two main activities usually associated with 'banking' are the acceptance of deposits and the lending of funds for business or other purposes.[21] In spite of this general perception, the two aspects of the business are subjected to very different types and levels of supervision. It is thus necessary to examine these two aspects separately. The deposit side of the equation is considered here, whilst the lending side of the equation is considered at a later stage.[22]

[18] It may be added in passing that this decision reflected a growing international trend to entrust monetary policy and market supervision to separate institutions.

[19] The transfer was effected by s 21 of the Bank of England Act 1998. The same Act also conferred independence upon the Bank of England in determining monetary policy, and established the Monetary Policy Committee for that purpose. Once again, this decision reflected a growing international trend and is consistent with the requirement for central bank independence for institutions forming a part of the European System of Central Banks.

[20] See Paget, para 1.1.

[21] Of course, matters are much more complex than this in practice. See, for example, the discussion on payment services in Chapter 5 below and relevant aspects of the Markets In Financial Instruments Directive at paras 3.26–3.52 below. For a recent case considering various aspects of the deposit-taking prohibition, see *Financial Services Authority v Anderson* [2010] EWHC 599 (Ch).

[22] See Chapter 4 below.

Acceptance of Deposits

1.10 Reference has already been made to the broad and inchoate nature of the FSMA. The so-called 'general prohibition' contains an excellent illustration of that general proposition. Section 19 provides that 'No person may carry on a regulated activity in the United Kingdom, or purport to do so, unless he is ... an authorised person ... or an exempt person ...'.

1.11 It is immediately obvious that the meaning of 'regulated activity' is central to the whole scheme of the regulatory system created by the FSMA. This line of enquiry then leads to section 22 of the FSMA, which provides that a 'regulated activity' is '… an activity of a specified kind which is carried on by way of a business and … relates to an investment of a specified kind … or ... in the case of an activity of a kind which is also specified for the purposes of this paragraph, is carried on in relation to property of any kind …'. At first sight, section 22 may not appear to advance matters in a particularly material way, but it does at least confirm that the Act only regulates activities which are carried on as a business; it does not apply to purely 'one-off' transactions or other dealings which cannot be said to be effected in the course of a business. The importance of this point will be discussed later.[23]

1.12 The FSMA further defines the activity of deposit-taking by a mere reference to 'accepting deposits'.[24] However, for real clarification of the nature of the general prohibition as it relates to deposit-taking, it is necessary to refer to the Regulated Activities Order.[25] In its turn, article 5 of the Regulated Activities Order provides that:

> (1) Accepting deposits is a specified kind of activity if—
> (a) money received by way of deposit is lent to others; or
> (b) any other activity of the person accepting the deposit is financed wholly or to a material extent out of the capital of or interest on the money received by way of deposit.
> (2) In paragraph (1), 'deposit' means a sum of money, other than one excluded by any of articles 6 to 9A,[26] paid on terms—
> (a) under which it will be repaid, with or without interest or premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it; and
> (b) which are not referable to the to the provision of property (other than currency) or services or the giving of security.
> (3) For the purposes of paragraph (2), money is paid on terms which are referable to the provision of property or services or the giving of security if, and only if—
> (a) it is paid by way of advance or part payment under a contract for the sale, hire or other provision of property or services, and is repayable only in the event that the property or services is or are not in fact sold, hired or otherwise provided;

[23] On the expression 'by way of business', see the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 (SI 2001/1177), as amended. This Order is considered at para 1.15 below.

[24] See FSMA, Sch 2, para 1.

[25] To provide its full title, the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544). As will be apparent from the present discussion, numerous orders have been made in reliance upon the powers delegated to the FSA under the 2000 Act. The Regulated Activities Order may, however, be regarded as the main source of law in the area now under consideration.

[26] The various exceptions and exclusions are discussed at para 1.13 below.

(b) it is paid by way of security for the performance of a contract or by way of security in respect of loss which may result from the non-performance of a contract; or
(c) without prejudice to sub-paragraph (b), it is paid by way of security for the delivery up or return of any property, whether in a particular state of repair or otherwise.

Article 5, when read together with section 19 of the FSMA, thus raises four questions, namely, (i) is a particular sum of money a 'deposit', (ii) if so, is the person concerned 'accepting' deposits for the purposes of article 5, (iii) if so, is he carrying on that activity by way of business, and (iv) if so, is he carrying on that business in the United Kingdom? If all of these questions are answered in the positive, then the relevant activity will be unlawful, unless either the person concerned is authorized or exempt, or the transaction itself is in some way exempt.[27] It is necessary to examine each of these issues in turn.

Deposits

1.13 First of all, when does a payment or transfer of money amount to a 'deposit'? In order to answer this question, it is necessary to examine the terms of the contract between the parties. If the deposit is to be repaid, either on demand or at a future date, with or without interest or premium, then on the face of it the relevant sum will be a 'deposit' for present purposes. A few points of interpretation flow from this apparently simple formulation:

(a) Article 5 requires that the relevant sum must be contractually repayable. It is submitted that this means that the deposit must be repayable in full, that is to say, without any deduction.[28] This view is reinforced by the words 'with or without interest or premium', which suggest that the depositor may receive back more than the amount of his original deposit, but not less.
(b) If the contractual arrangements envisage situations in which the depositor may receive repayment of less than the original principal amount, then the arrangement does not amount to a deposit. In such cases, it must generally be assumed that the payer is assuming greater risk for greater reward, and that there is thus some form of risk or speculative element involved in the deal. Entities offering arrangements of this kind will often require authorization under other provisions of the FSMA,[29] but the arrangement does not fall within the scope of the deposit-taking restriction in article 5.
(c) Similarly, the expression 'repaid' connotes that the deposit must be repaid in money. Consequently, payments made for stored value cards entitling the holder to the use

[27] On exempt persons, see para 1.19 below.

[28] This requirement may have to be subject to the minor exception that deductions can be made on account of normal bank charges but, nevertheless, the deposit is still repaid in full in the sense that the customer receives a discharge for liabilities which he would otherwise have to pay directly. Sums deposited with a bank may become subject to a right of set-off in the hands of the bank but, again, it is submitted that this does not alter the fundamental nature of the transaction as a deposit; the customer will still receive full credit for the amounts deposited with the bank, even though it may have the right to refuse their subsequent re-transfer or repayment to the customer. The requirement that a deposit must be repaid in full has caused some difficulty in the authorization of institutions wishing to offer Islamic-compliant products: see the discussion at paras 50.17–50.19 below.

[29] eg on the basis that they are carrying on investment business or managing a collective investment scheme for the purposes of art 53 of the Regulated Activities Order.

of public transport or telephones do not amount to deposits, because the payer is not generally entitled to redeem the card for cash.[30]

(d) A sum of money thus only constitutes a deposit if its initial payment creates a debtor-creditor relationship between the parties, imposing upon the bank an obligation to repay the monies in full regardless of the success of any venture in which the bank may choose to invest those funds.[31] This view is consistent with the general view of the banker-customer relationship.[32]

(e) The exceptions from the definition of 'deposit' set out in article 5(2)(b) (read together with article 5(3)) of the Regulated Activities Order are of some importance in practice. In essence, these provisions exclude any payments which are referable to the provision of goods or services, or the taking of security. Thus, a landlord who takes a dilapidations deposit from his tenant is not accepting a 'deposit' for the purposes of the Regulated Activities Order.[33] Likewise, a broker who accepts cash margin as security for dealings in commodities or financial futures is not accepting a 'deposit', since the payment is referable to the provision of dealing services and is intended as security for the customer's obligations.[34]

(f) Certain payments of money are stated not to constitute deposits even though they might otherwise meet the definition of that term. The list of exempt payments[35] includes:

  (i) sums paid by the Bank of England, the central bank of an EEA State, the European Central Bank, the European Community or certain international financial institutions;

  (ii) sums paid by a person authorized under the FSMA to accept deposits or to carry out insurance business, or by a person whose business consists wholly or to a significant extent in lending money;[36]

  (iii) sums paid by a local authority;

  (iv) sums paid among companies which are members of the same group;

  (v) sums paid among close family members;[37]

  (vi) sums paid to a solicitor in the course of his profession;

[30] It should however be noted that issue of e-money is a regulated activity: see the discussion in n 39 below.

[31] Since money is fungible in any event, it is difficult to see how the customer's right to repayment could be linked in this way.

[32] See *Foley v Hill* (1848) HL Cas 28 and the discussion of this point at paras 15.09–15.16 below.

[33] This point is made explicit by art 5(3)(c) of the Order.

[34] See arts 5(3)(a) and (b) of the Order. The point is confirmed by the decision in *SCF Finance Co Ltd v Masri* (No 2) [1987] 1 All ER 175.

[35] For the full list, see arts 6–9A of the Regulated Activities Order.

[36] As a result, a person does not accept deposits for FSMA purposes if he borrows from a bank, insurance company or other money lending entity.

[37] Whilst this clarification is useful, such arrangements would normally fall outside art 5 because they would not have been entered into by way of business. On this subject, see para 1.15 below. The exemption was discussed in *Financial Services Authority v Anderson* [2010] EWHC 599 (Ch) but was of no assistance to the defendants in that case, where loans were raised from a range of individuals only some of whom were close relatives.

(vii) sums paid by way of consideration for the issue of debentures or government securities;[38] and

(viii) sums paid in consideration of an immediate provision of electronic money.[39]

Accepting Deposits

1.14 If the transaction involving the payment of money does amount to a deposit, then it becomes necessary to determine whether the relevant entity is 'accepting deposits' for the purposes of the Regulated Activities Order. It will be recalled that the prohibition only applies where either (i) the monies so received by way of deposit are lent to others or (ii) the business of the person accepting the deposit is financed, wholly or to a material extent out of the capital of, or interest received on, those deposits.[40] If the accepting entity is itself a money lender, then the first criterion will almost inevitably be met, with the result that the entity concerned will be 'accepting deposits' for these purposes. In other cases, it will be necessary to determine whether the second criterion is satisfied, and this may involve difficult assessments of a factual nature. It has to be borne in mind that not all funding received by an entity through the means of debt finance will necessarily constitute a deposit which falls to be taken into account for these purposes. For example, as has been seen,[41] monies received from an authorized institution do not amount to the receipt of deposits by the borrowing entity. Consequently, they would not fall to be treated as deposits in making the necessary assessment.

Carrying on a Business

1.15 If the first two tests have been met, then it will finally be necessary to determine whether the relevant deposits were accepted in the course of a business. This can often be a delicate question in a number of contexts.[42] In the present case, it is specifically provided that a person should not be regarded as accepting deposits if (i) he does not hold himself out as accepting deposits on a day-to-day basis and (ii) any deposits which are accepted are taken only on particular occasions, whether or not involving the issue of securities.[43]

[38] Where the debentures constitute short term sterling commercial paper, they will only benefit from this exemption if the subscribers are investment professionals and the face amount of the paper exceeds £100,000—see art 9 of the Regulated Activities Order.

[39] Article 9A of the Regulated Activities Order, as inserted by art 3(2) of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2002 (SI 2002/682). It may be noted that the issue of electronic money involves an obligation on the issuer to make payments (effectively, on behalf of the holder) to retailers which accept the use of the e-money. Consequently, the issuer of the e-money is accepting a deposit which has to be repaid at a later date. This may be contrasted with the position of a stored value card, which involves the provision of services (rather than the repayment of money) and is thus not caught by the legislation now under discussion. Whilst the issue of e-money is specifically stated not to constitute the acceptance of a deposit, issuers are subject to the different regime established by arts 9B–9K of the Regulated Activities Order.

[40] See para 1.12 above.

[41] See para 1.13 above.

[42] For cases decided in different statutory contexts, see *Davies v Sumner* [1984] 1 WLR 1301 (HL) and *R&B Customs Brokers v United Dominions Trust Ltd* [1988] 1 WLR 321 (CA). For a recent illustration of this type of problem, see *Khodari v Tamimi* [2008] EWHC 3065.

[43] Article 2(1) of the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 (SI 2001/1177), as amended. In determining whether deposits are accepted only on

This clarification may be useful in various contexts. For example, a joint venture company which is owned in precisely equal shares[44] may need to raise funds from time to time and will naturally approach its investors to make the necessary cash advances. This will not amount to an acceptance of deposits by the joint venture company, since it does not hold itself out as accepting deposits generally and only does so for the purpose of funding its particular activities.[45]

In the United Kingdom

1.16 If all of the above tests have been met, then it is necessary to ask whether the relevant business is being carried on 'in the United Kingdom'. Quite apart from questions of UK statutes and their territoriality, it will be recalled that this requirement explicitly forms a part of the general prohibition.[46]

1.17 Once again, whether or not a particular business is being carried on in the United Kingdom can be a delicate question. For example, the mere fact that a foreign banker makes occasional trips to the United Kingdom to visit customers in the UK should not lead to the conclusion that his bank is carrying on business in the UK.[47] A bank cannot be deemed to be carrying on business in every country in which it happens to have customers. There will, inevitably, be difficult questions of fact and degree.

1.18 The FSMA does provide a certain amount of guidance in this area, although it must be said that the effect of these provisions is to 'import' into the United Kingdom business which might otherwise be considered to be carried on outside of the UK. The provisions which are relevant to deposit-taking business are as follows:

(a) A UK company which is entitled to carry on deposit-taking business in another EEA State[48] and which carries on that activity in such a State is deemed also to be carrying on that business in the United Kingdom.[49] This slightly convoluted provision reflects the requirement that any entity carrying on activities covered by the Single Market Directives in relation to banking and financial services must be authorized for that purpose in its home State.[50]

'particular occasions', it is necessary to consider (i) the frequency of those occasions and (ii) any characteristics which distinguish those occasions from each other: see art 2(2) of that Order.

[44] ie so that the joint venture company is not a subsidiary of either shareholder and thus does not qualify for the 'group' deposits exemption noted at para 1.13 above.

[45] This analysis is not entirely free from difficulty. In order to satisfy the 'particular occasions' test, it is necessary to have regard to the frequency of the occasions and any characteristics which distinguish them from each other (see art 2(2) of the By Way of Business Order mentioned in n 44 above. If cash advances are requested on a frequent basis and for a variety of different purposes, then it may be more difficult to satisfy the 'particular occasions' test: see *Financial Services Authority v Anderson* [2010] EWHC 599 (Ch).

[46] See FSMA, s 19 reproduced at para 1.10 above.

[47] For the consequences of this type of activity in the context of the EC 'passporting' regime, see paras 2.25–2.28 below.

[48] The expression 'EEA States' comprises the Member States of the European Union plus Iceland, Liechtenstein and Norway.

[49] FSMA, s 418(1).

[50] On the principle of home State supervision in this context, see the discussion of the passporting regime at paras 2.13–2.17 below.

(b) A UK company will be deemed to be carrying on business in the United Kingdom if it is carrying on a regulated activity whose day-to-day management is the responsibility of its registered office or an establishment in this country.[51] Thus, even though a company may be offering deposit-taking services exclusively to persons outside the United Kingdom, it will still require authorization if its operations are 'based' in the UK.

(c) A foreign entity whose head office is abroad but which carries on a regulated activity through an establishment in the United Kingdom will be deemed to be carrying on that business in the United Kingdom even though it has no customers in the UK.[52] In relation to foreign companies, this is essentially a mirror image of the provision described in (b) above.

For these purposes, it will not always be easy to say whether or not a particular entity has an 'establishment' in the UK. That issue is, however, discussed in another context.[53]

Exempt Persons

1.19 If deposits are being accepted in the course of a business carried on in the United Kingdom, then it becomes necessary to consider whether the person accepting the deposits is in some way exempted from the provisions of the FSMA. The Treasury has power to exempt persons (or specified classes of persons) from the scope of the general prohibition created by section 19(1) of the FSMA.[54] The exemptions may be given generally or may relate only to specific transactions or circumstances. A number of institutions and organizations—including municipal banks, credit unions and industrial and provident societies—have been granted exempt status in relation to the prohibition against the acceptance of deposits.[55]

Consequences of Contravention

1.20 Apart from the criminal sanctions for breach of the general prohibition against the unauthorized acceptance of deposits,[56] it should be noted that an agreement entered into by a person in the course of carrying on a regulated business without the appropriate permission from the FSA will be unenforceable against the other party.[57] The other party will generally be entitled to recover both the funds paid by him and appropriate compensation.[58]

1.21 However, whilst the criminal aspect of the above provisions applies to the unlawful acceptance of deposits, the civil consequences do not.[59] It is not immediately clear why this should be the case. If a person places a deposit with an unauthorized person for a return

[51] FSMA, s 418(2).
[52] FSMA, s 418(5).
[53] See para 2.28 below.
[54] The power is conferred by FSMA, s 38. The Act itself confers exemption on 'authorized representatives' who carry on a regulated activity under contract with a person who holds a permission for the relevant activity under the terms of the Act: see s 39 of the Act.
[55] See art 4 of the Financial Services and Markets Act 2000 (Exemptions) Order 2001 (SI 2001/1201).
[56] The criminal penalties are set out in FSMA, s 23.
[57] See FSMA, s 26(1). On s 26, see *Brodenik and others v Centaur Services Ltd* (27 July 2006), noted by Blair, Walker and Purves, para 7.14.
[58] FSMA, s 26(2).
[59] See FSMA, s 26(4).

which is below the market rate, he should be entitled to appropriate compensation as well as repayment. It is true that the FSMA allows for an application to court for immediate repayment of the deposit regardless of its stated maturity date,[60] but no specific provision is made for compensation in this particular case.

The Authorization Procedure

1.22 If an entity wishes to accept deposits by way of business in the United Kingdom and none of the available exemptions apply, then it will be necessary to seek authorization for that purpose in order to avoid a contravention of the FSMA.[61] The required authorization is frequently referred to as a 'Part IV permission', since the details of the authorization process are set out in that Part of the FSMA.[62] Given that the objectives of the authorization process include the protection of consumers and the promotion of confidence in the financial markets,[63] it is unsurprising that the main criteria to be taken into account in assessing such an application revolve around the financial soundness and managerial integrity of the entity concerned.

1.23 The starting point in relation to any application for Part IV permission is that the applicant must meet the so-called 'threshold conditions' for that purpose.[64] The principal conditions are:

(a) an entity applying for permission to accept deposits must be a body corporate or a partnership;[65]
(b) the applicant must maintain its head office in the UK;[66]
(c) if the applicant is a member of a group of companies or any person directly or indirectly controls more than 20 per cent of the voting rights or capital of the applicant—or the applicant controls 20 per cent of another entity—the FSA must be satisfied that those relationships are not likely to prevent the FSA from effective supervision;[67]
(d) the applicant must have sufficient financial resources for the regulated activities which the entity proposes to carry on;[68] and

[60] See FSMA, s 29.
[61] This statement follows from the terms of the general prohibition contained in FSMA, s 19 and to which reference has already been made.
[62] The expression 'Part IV permission' is defined in FSMA, s 40(4).
[63] These objectives are to be taken into account by the FSA in the exercise of all of its statutory functions: see FSMA, s 2(2).
[64] The general requirement is imposed by FSMA, s 41 and the threshold conditions themselves are set out in Sch 6 to that Act.
[65] FSMA, Sch 6, Pt I, para 1(2). Although private individuals are able to apply for authorization from certain types of regulated activities under the FSMA, they are not permitted to apply in relation to the 'accepting deposits' activity.
[66] FSMA, Sch 6, Pt I, para 2.
[67] Where the applicant has close links with an entity established outside the EEA, the FSA must also be satisfied that neither the administrative regulations in force in that country nor any deficiency in their enforcement will prevent the FSA's effective supervision of the applicant. On the points made in this paragraph, see FSMA, Sch 6, Pt I, para 3.
[68] FSMA, Sch 6, Pt I, para 4. This is a general, threshold test, without any specific monetary requirements. The amount would clearly depend on the nature, scope, and extent of the business which the applicant seeks

(e) the applicant must demonstrate that it is a 'fit and proper person' to hold the requested permission, bearing in mind any connections with other persons, the nature of the regulated business to be conducted and the need to ensure that business is conducted soundly and prudently. In practice, this will involve a consideration of the individuals who may be involved in the management of the business (who must be separately approved by the FSA for this purpose) or who may be significant shareholders.[69]

1.24 Compliance with the threshold conditions is a continuing requirement. Consequently, when deciding whether to grant an application for deposit-taking permission, the FSA must satisfy itself that the applicant meets the threshold conditions *and will continue to do so.*[70] The FSA may withdraw the authorization to accept deposits (or, indeed, any other permission) if the relevant entity subsequently fails to meet those conditions or is likely to do so.[71] Thus, for example, when the FSA determined that Kaupthing Singer & Friedlander—a UK authorized institution—no longer satisfied the 'adequate resources' test, it imposed upon that bank a requirement that it should cease to accept any further deposits.[72] Likewise, continued compliance with the 'fit and proper person' test must to a large degree depend on the identity of those who can exercise a significant measure of control over the affairs of the institution, and this may obviously change over time. Accordingly, any person who proposes to acquire or to increase a significant shareholding over an authorized institution should notify the FSA in advance and obtain approval. If the acquisition occurs without prior notification to the FSA and it does not approve the new arrangements, then the FSA may bar the exercise of voting rights and apply to the court for an order that the relevant shares be sold.[73]

1.25 The above discussion has focused on authorization for the acceptance of deposits, since that is the key and distinguishing characteristic of banking business. It should, however, be appreciated that a bank would require further permissions for many of its other activities, including, to name but a few, (i) entering into regulated mortgage contracts,[74] (ii) managing investments,[75] and (iii) advising on investments.[76]

to conduct. In determining this test, the FSA can take into account resources available from other members of the same group, and can also have regard to the quality of the applicant's risk management processes.

[69] FSMA, Sch 6, Pt I, para 5.

[70] FSMA, s 41(2). Note that, in giving permission, the FSA may impose such conditions as it believes appropriate, whether as to the applicant's conduct of business, its relationships with other businesses, or otherwise: see FSMA, s 43.

[71] The necessary power (referred to as the FSA's 'Own Initiative' power) is conferred by FSMA, s 45. Permission may also be withdrawn if it is desirable to protect consumers, or if the relevant entity has effectively ceased to carry on any regulated business.

[72] See the FSA's First Supervisory Notice addressed to Kaupthing Singer & Friedlander dated 8 October 2008.

[73] The details of these procedures, including rights of appeal and other matters, are set out in Pt XII of the FSMA. For present purposes, it is the general scheme of the legislation, rather than its detail, which is of relevance. However, notification and FSA approval is required if a person intends to acquire 10 per cent of any institution or to enter into arrangements involving significant influence over its business. For details, see FSMA, s 179.

[74] Regulated Activities Order, art 61, on which see paras 4.43–4.54 below.

[75] Regulated Activities Order, art 37.

[76] Regulated Activities Order, art 53. For a discussion of certain aspects of investment activities carried out by banks for their customers, see paras 3.26–3.52 below.

Powers of the FSA

1.26 Reference has already been made to some of the powers of the FSA in the context of the initial authorization of a credit institution, the threshold conditions and the 'fit and proper person' test. However, regulation and supervision are ongoing processes and it is therefore unsurprising that the FSA also enjoys extensive information-gathering and investigatory powers. These are set out in Part XI (sections 165–177) of the FSMA and include the following:

(a) Power to require an authorized person to produce information and/or documents specified by the FSA,[77] but the power is limited to material reasonably required by the FSA for the purpose of exercising its functions.[78] The power extends to other entities which are in the same group as the authorized institution.

(b) Power to require an authorized person (or any member of the same group) to provide to the FSA a 'skilled person's' report[79] on any documents produced or required to be produced pursuant to the provisions described in (a) above. It may be noted that it is the duty of any person who has provided services to the relevant authorized person to provide such assistance as the skilled person may reasonably require.[80] This would presumably include accountants, lawyers and others who may have advised the bank on matters connected with the subject matter of the proposed report. However, it would seem that the skilled person could not require the disclosure of any information which is subject to legal professional privilege.[81]

(c) The FSA may appoint one or more competent persons to investigate the nature, conduct, or state of the business conducted by an authorized person, a particular aspect of that business or its ownership or control.[82] The investigatory powers of the competent person extend to group members and to entities which were formerly authorized.[83] Since they may have an impact on the financial health of the authorized person, the investigatory power also extends to any non-regulated business carried on by the authorized person concerned.[84]

(d) The FSA also has a more specific power to appoint a person to carry out an investigation on its behalf if it has grounds for believing that particular criminal offences (including offences such as market abuse or insider trading) may have been committed or if there has been any contravention of certain other rules.[85]

[77] FSMA, s 165.
[78] FSMA, s 165(4).
[79] On this power, see FSMA, s 166. The 'skilled person' is nominated by the FSA and the selection will obviously depend upon the particular subject matter at issue. See FSMA, s 166(4).
[80] FSMA, s 166(5).
[81] ie essentially for the reasons given in *R v Special Commissioner, ex p Morgan Grenfell & Co Ltd* [2003] 1 AC 563 (HL).
[82] FSMA, s 167(1). The section confers a like power on the Secretary of State.
[83] FSMA, s 167(2), (3) and (4).
[84] FSMA, s 167(5).
[85] FSMA, s 168. Once again, a parallel power is conferred on the Secretary of State. The investigatory powers may be exercised in relation to suspected misconduct and the possible use of the FSA's own disciplinary powers: see *Financial Services Authority v Westcott* [2003] EWHC 2392 (Comm).

(e) In view of the international nature of the financial markets and the fact that suspected wrongdoing will frequently involve conduct in more than one jurisdiction, the FSA has power to assist an investigation by an overseas regulator[86] by initiating its own investigation in line with the powers described above.[87] Where the request comes from a regulator in another Member State, there may in some cases be a Community law obligation to provide the requested assistance.[88] Subject to that, however, and in deciding whether to provide assistance in this way, the FSA must take into account (i) whether reciprocal assistance would be forthcoming, if requested, (ii) whether the investigation involves activities which would be unlawful or would contravene regulatory requirements in the United Kingdom, (iii) the seriousness of the case and any relevance to the United Kingdom, and (iv) whether it is otherwise in the public interest to provide the requested assistance. The discretion to assist overseas regulators may not, however, be as broad as it first appears. In *R (on the application of Amro International SA) v Financial Services Authority*,[89] the FSA was asked to assist the US Securities and Exchange Commission (SEC) in an ongoing civil action involving fraudulent trading in company stock. The SEC requested documentation from a UK firm of accountants in relation to two entities which were not the target of the SEC allegations, on the basis that this information was required to assist in explaining the relationship between some of the entities which were under investigation. At first instance, the court held that there had been no assertion that the two entities concerned were knowingly involved in share manipulation, nor had it been suggested that the main target of the investigation had any interest in either of these two entities. As a result, the court granted judicial review of the decision to appoint the investigator insofar as it related to these two, specific entities. However, this judgment has recently been reversed on appeal, on the basis that the FSA had properly exercised its powers and was not required to second guess the motives or objectives of the overseas regulator.[90]

(f) Various notice and other procedural requirements apply in relation to the instigation and conduct of the investigations described above.[91] The investigator has power to require the person under investigation to answer questions, to provide information and to produce documents.[92] As a general rule, statements made to an investigator are admissible in court proceedings but this is strictly limited where the target of the investigation is subsequently charged with a criminal offence.[93]

[86] 'Overseas regulator' means a corresponding regulator under the EC's Recast Banking Consolidation Directive or a regulator from a third State exercising functions essentially similar to those of the FSA itself: see FSMA, s 195(3).

[87] See FSMA, s 169.

[88] FSMA, s 169(3).

[89] [2009] EWHC 2242 (Admin).

[90] [2010] EWCA Civ 123 (CA).

[91] FSMA, s 170.

[92] See FSMA, ss 171, 172 and 173. In certain cases, s 175 empowers the investigator to require the production of information by third parties. A warrant may be issued to obtain documents and information if a person has failed to provide them on request: FSMA, s 176.

[93] FSMA, s 174.

(g) Unsurprisingly, a person who fails to comply with a documentation or information request made for the purposes of an investigation, or who destroys or falsifies any relevant material, may be guilty of an offence, unless he has a reasonable excuse.[94]

EEA Firms

1.27 In accordance with the terms of Community legislation in this sphere, a credit institution[95] established in another EEA State[96] and which is authorized by its home State regulator is entitled to be treated as authorized in the United Kingdom to the same extent. The whole subject is dealt with in more detail at a later stage.[97]

[94] FSMA, s 177.

[95] In accordance with the terms of Art 1 of the Recast Banking Consolidation Directive, a 'credit institution' is '… an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account…'. The Directive is discussed in more detail in Chapter 2 below.

[96] As noted previously, 'EEA State' includes each EU Member State plus Iceland, Liechtenstein and Norway.

[97] See Chapter 2 below.