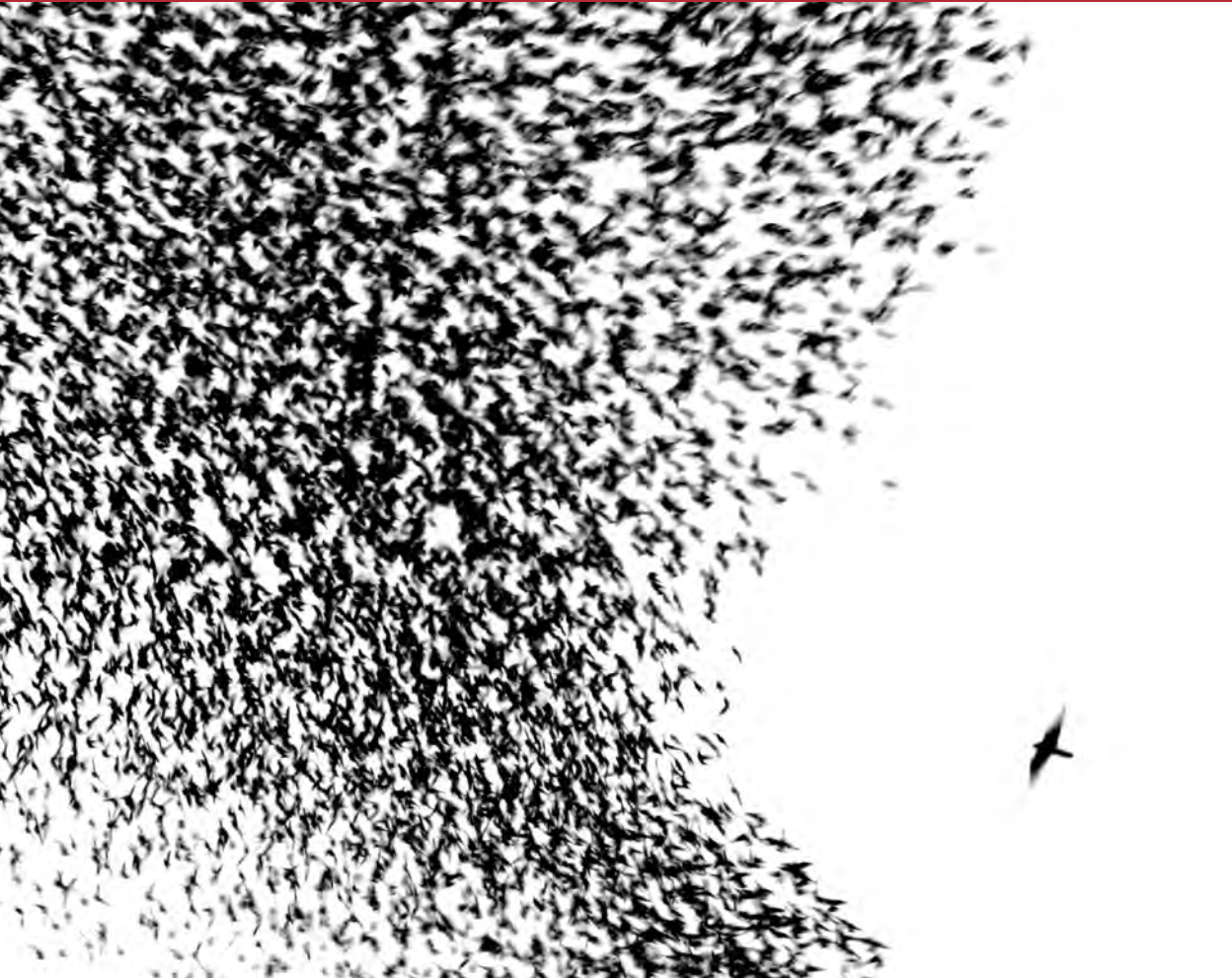


Serious Economic Crime

A boardroom guide to prevention and compliance



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Serious financial crime in the financial services sector

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We live in a world of uncertainty. The longer-term future of a standalone Serious Fraud Office (SFO) is in doubt although for the time being it will continue to work with the economic crime command within the National Crime Agency – as it will with the City of London Police and other relevant criminal justice agencies at home and abroad.¹

Meanwhile, the Financial Services Authority (FSA) is being abolished in 2012 in favour of two new agencies – the Prudential Regulation Authority and the Financial Conduct Authority – and its enforcement powers transferred.

The Financial Services and Markets Act

Under the Financial Services and Markets Act 2000 (FSMA), one of the statutory objectives of the FSA is “the reduction of financial crime – reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime”.

This broad objective rather understates the enforcement powers of the regulator, since, apart from Part V of the Criminal Justice Act 1993 (which sets out the criminal offence of insider dealing, for which the FSA is a prosecuting authority), it has the power to prosecute several specific offences relating to regulated activities. Some of these are ‘summary’ and can only be dealt with by the magistrates’ courts. Others are ‘indictable’ and can only be heard in the crown court, where a jury decides on guilt. Yet others are ‘either way’, and so can be tried either in a magistrates’ or crown court. Punishments include fines at various levels and imprisonment for up to seven years.

Jurisdiction to prosecute and the relationship between the FSA and SFO

The SFO, as its name implies, concentrates on investigating and prosecuting fraud – that is, acts of deception intended for personal gain or to cause loss to another. Of course, fraud comes in many flavours and is usually a civil wrong as well as a crime. Both the SFO and FSA are empowered to take civil proceedings to secure the proceeds of crime, including funds believed to have been salted away abroad.

After a conviction for fraud, the court will invariably be asked to consider making a confiscation order under the Proceeds of Crime Act 2002 (POCA)

for the lesser of any benefit from the crime, or all the defendant's net assets. A default prison sentence of up to ten years consecutive will be imposed, and so in FSMA cases this penalty may exceed the sentence for the crime itself. A restraint order may also be granted to the prosecutor even at the investigative stage to prevent dissipation of assets.

The SFO may also prosecute on behalf of the FSA and works closely with external agencies such as the FSA.

Significantly, however, in the 2010 Supreme Court case of *R v Rollins (Neil)* and *R v McNerney (Michael)*, it was decided that the FSA's powers to prosecute criminal offences were not limited to the offences set out in FSMA Sections 401 and 402. So in *Rollins* the FSA had the power to prosecute offences of money laundering contrary to POCA Sections 327 and 328.

Essentially, the FSA can act as a private prosecutor, since generally any person can bring a private prosecution. Clearly, money laundering can be a consequence of the commission of an offence under the FSMA, such as carrying on a regulated activity without authorisation.

Impact on victims

Arguably the most serious offences under the FSMA are those of carrying on a regulated activity without authorisation and making misleading statements to induce investments.

Doing so can have very serious consequences for the victim or consumer, who will typically have 'invested' large amounts of money in unauthorised schemes, which often take the form of collective investment schemes (CIS), and will be unable to recover their money from the unauthorised operators of the scheme.

Neither will they have access to the Financial Ombudsman Service if they wish to make a complaint, and they will not be covered by the Financial Services Compensation Scheme.

Increasingly the FSA will obtain civil freezing orders against these operators, but in practice it is often too little too late, despite the fact that under

Section 26 of the FSMA "an agreement made by a person in the course of carrying on a regulated activity in contravention of the general prohibition is unenforceable against the other party".

Such activities may have generic characteristics – they may be pyramid or 'easy money' schemes – that make any recovery all but impossible. 'Boiler rooms', which sell often worthless investments and target UK-based consumers though they are operated from abroad, may also fall into this category since communicating an inducement or invitation to engage in investment activity (in the absence of authorisation) is also prohibited under Section 21 of the FSMA – if it is "capable of having an effect in the United Kingdom".

Offences under the FSMA

The most serious criminal offences and incidents of misconduct in the financial services sector that fraud practitioners are likely to encounter are:

- carrying on a regulated activity without authorisation. This is described in Sections 19 and 23 of the FSMA as a breach of the general prohibition
- communicating an invitation or inducement to engage in investment activity
- making misleading statements to induce investments.

Carrying on a regulated activity without authorisation

Section 19 of the FSMA 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. The prohibition is referred to in this Act as the 'general prohibition'.

Under Section 23 of the FSMA, it is a criminal offence to contravene the general prohibition and punishable in the magistrates' court with six months' imprisonment and/or a fine of £5,000; in the crown court it is punishable with two years' imprisonment and/or an unlimited fine.²

The offence is committed through breach of

the prohibition and no specific intent is required, although it is a defence under Section 23 for “the accused to show that he took all reasonable precautions and exercised all due diligence to avoid committing the offence”. The issues are:

- **Is the accused carrying out a regulated activity?** An activity, for the purposes of this Act, is one of a specified kind that is carried on by way of business and (a) relates to an investment of a specified kind; or (b) is carried on in relation to property of any kind (Section 22). Schedule 2 of the FSMA (which has been subject to a series of amending orders) sets out the parameters of such activities and includes offering investment advice, deposit taking, managing investments and establishing a collective investment scheme.³
- **Is the regulated activity being carried out in the UK?** Section 418 elaborates on when regulated activities will be considered to be carried out in the UK and also relevant is Section 21 of the FSMA, as described above.
- **If so, is the accused an authorised or exempt person?** Those who are authorised persons are set out in Section 31 of the Act and in most cases will have FSMA Part IV permission to carry on one or more regulated activities. The Treasury may, by an exemption order, provide for specified persons, or persons falling within a specified class, to be exempt from the general prohibition.
- **Even if the accused is not actually carrying out a regulated activity, is he purporting to do so?** It is likely that the reasoning in *Securities and Investments Board v Scandex Capital Management A/S* (1998), in relation to the equivalent provisions in the Financial Services Act 1986, will be held to apply to the FSMA – and a mistake of law as to the need for authorisation will therefore not give rise to a defence.⁴
- **Has the accused taken all reasonable precautions and exercised all due diligence to avoid committing the offence?** The evidential burden is on the accused to prove this on a balance of probabilities.

Collective investment schemes

Establishing, operating or winding up a collective investment scheme constitutes a regulated activity. Such schemes are described in Section 235 of the FSMA as:

(1) ... any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

(2) The arrangements must be such that the persons who are to participate ('participants') do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.

(3) The arrangements must also have either or both of the following characteristics –

(a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;

(b) the property is managed as a whole by or on behalf of the operator of the scheme.

Under FSMA Section 238 (Restrictions on promotion), only certain kinds of collective investment scheme may be promoted to the public by an authorised person.

Under Section 284, the FSA or the Secretary of State can appoint a person to carry out an investigation into a collective investment scheme.

Very often an investigation into a breach of the prohibition will reveal, or arise from, the operation of a CIS. Of course not all these schemes are illegal; a classic CIS is a unit trust, which is generally operated under appropriate FSA authorisation by a reputable body. However, other types of unauthorised scheme that have been investigated, and sometimes prosecuted, include the provision of a betting service that involved collecting money from the public and placing bets on their behalf on horse races.⁵

Another example was an ‘easy money’ scheme in which a substantial investment business primarily involved investing in a pyramid scheme (see the case study below).

Recently, there have also been a number of so-called ‘land banking’ schemes, which involve persuading people to invest in plots in the green belt, on the improbable basis that the land will rocket in value when planning permission is secured for building houses; the profits to the unauthorised land bankers from buying land at agricultural prices and selling for development have been phenomenal.

The CIS issue here is an alleged promise by the operators to apply for planning permission on behalf of the plot buyers, or otherwise manage the plots for them after purchase. The FSA takes the position that this amounts to the pooling of assets and depriving the plot holders of day-to-day management. Although trading in land is not in itself a regulated activity under the FSMA, the property concerned in a CIS can be any property, including land.

In some of these cases, the offences of fraud by misrepresentation and money laundering⁶ are also engaged.

Communicating an invitation or inducement to engage in investment activity

Section 23 of the FSMA provides that a person must not, “in the course of business, communicate an invitation or inducement to engage in investment activity” save where the person is an authorised person or where “the content of the communication is approved for the purposes of this section by an authorised person”.

An offender is liable on summary conviction to imprisonment for up to six months and/or a fine not exceeding £5,000, and on indictment up to two years’ imprisonment and/or an unlimited fine.

Detailed issues that may arise are:

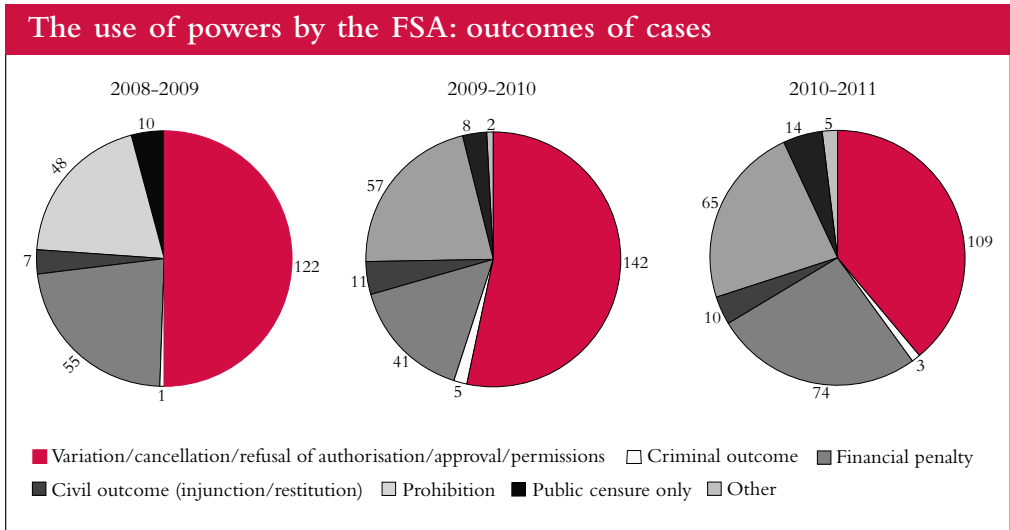
- **Is the communication in the course of business?** Normally this will be a straightforward issue, but the Treasury may

specify circumstances in which a person is deemed to be acting in the course of business, or not.

- **Is there a communication?** ‘Communicate’ includes causing a communication to be made and Order 2005 (Financial promotion) in the FSMA deems what may be a ‘communication’. It may be, for example, to an individual, or a class or group of persons, by written, electronic or other means.⁷
- **Is there an invitation or inducement?**
- **Is there engagement in an investment activity?** ‘Engaging in investment activity’ means (a) entering or offering to enter into an agreement – the making or performance of which by either party constitutes a controlled activity; or (b) exercising any rights conferred by a controlled investment to acquire, dispose of, underwrite or convert a controlled investment (Section 21). Clarification of ‘controlled activity’, ‘controlled investment’, ‘specified class of activity’ and ‘specified class of investment’ is provided in separate FSMA Orders.
- **Is there a defence?** Under Section 25 of the FSMA, it is a defence for the accused to show that he believed on reasonable grounds that the content of the communication was prepared or approved by an authorised person, or that he took all reasonable precautions and exercised all due diligence to avoid committing the offence. Under Section 21, in the case of a communication originating outside the UK, the restriction applies only if the communication is capable of having an effect in the UK.

Misleading statements and practices

Section 397 of the FSMA creates criminal offences concerning misleading statements and practices, punishable by up to seven years’ imprisonment and/or an unlimited fine. An offence is committed where a person deliberately makes a misleading statement, promise or forecast, or dishonestly conceals facts from someone with



the intention of inducing another to do, or refrain from doing, something in relation to an investment. A possible example of this offence would be someone lying about a company’s financial position at a time when he was seeking to dispose of shares in that company,⁸ but it can also include misleading information communicated to prospective investors in an unauthorised CIS.

A person is guilty of an offence if he:

- makes a statement, promise or forecast that he knows to be misleading, false or deceptive in a material particular
- dishonestly conceals any material facts whether in connection with a statement, promise or forecast made by him or otherwise
- recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular ...
- for the purpose of inducing, or is reckless as to whether it may induce, another person to enter, or refrain from entering, a relevant agreement, or to exercise, or refrain from exercising, any rights conferred by a relevant investment.

A ‘relevant agreement’ is one that constitutes an activity of a kind specified in Section 397 of the FSMA, or falls within a specified class of activity; and relates to a relevant investment.

A further offence is committed, under Section 397, by a person who engages in any course of conduct that creates a false or misleading impression as to the market in, or the price or value of, any relevant investments – if he does so for the purpose of creating that impression and of thereby inducing another person to acquire, dispose of, subscribe for or underwrite those investments, or to refrain from doing so, or to exercise, or refrain from exercising, any rights conferred by those investments.

There is a statutory defence under Section 397 if the accused can show:

- that he reasonably believed his actions or conduct would not create an impression that was false or misleading
- that he acted, or engaged in the conduct, for the purpose of stabilising the price of investments, and in conformity with price-stabilising rules
- that he acted in conformity with control-of-information rules

- that he acted in conformity with the relevant provisions of Commission Regulation (EC) 2273/2003.

Section 397 does not apply unless the act is carried out, or the course of conduct engaged in, in the UK, or the false or misleading impression is created there. It is important to note that these offences may be committed by unauthorised persons, such as those who are in breach of the general prohibition, by, for example, running an unauthorised CIS.

Other offences that may arise in fraud investigations are:

- it is an offence under Section 24 to falsely claim to be authorised by the FSA or to be an exempt person, or to behave as such although the due-diligence defence is available. This is a summary offence for which the sanction is six months' imprisonment and/or a £5,000 fine. The fine may be increased if there is a public display of any misleading material
- it is an offence under Section 398 to knowingly or recklessly give the FSA information that is false or misleading in a material particular in purported compliance with any requirement under the FSMA. In either a magistrates' court or a crown court, this is punishable by a fine.

Case study: Kevin Foster

In 2010, Kevin Foster was convicted of defrauding investors through his various schemes, collectively known as the KF Concept. Foster attracted £34 million from investors by promising very high returns on a variety of gambling and network marketing activities. It was alleged that little of the money was in fact used for such activities, but that millions were poured into an offshore pyramid scheme. Meanwhile, Foster paid himself and his close associates handsomely from KF Concept money and they lived extravagant lifestyles. The case was prosecuted by the SFO on behalf of, and in conjunction with, the FSA, which had

previously investigated and intervened in the KF Concept with civil freezing orders.

Foster was charged with eight offences under the FSMA and eight offences under the Theft Act 1968. The FSMA offences included:

- communicating an investment or inducement to engage in investment activity, contrary to Sections 21 and 25
- not being an authorised person carrying on a regulated activity, contrary to Sections 19 and 23.
- concealing a material fact, contrary to Section 397.

Foster was said to have promised unrealistic returns on a series of gambling schemes initially based on football league betting, and increasingly on a pyramid scheme format. His personal charisma and his 'magic touch' were central to the marketing. His schemes were said by the SFO to have had the characteristics of a collective investment scheme in that investors' money was pooled, the pool was managed by Foster, and the investors had no day-to-day control over their funds.

Communication

Communication was by word of mouth – via family and friends and friends of friends and so on – and was important as a means of raising money. But a major fundraising strategy for the scheme was the holding of roadshows nationwide. These became increasingly well attended and successful in raising money. They would usually include what was described by the SFO as a barnstorming and rabble-raising talk by Foster, full of confidence, optimism and bluster, but short on detail.

Carrying on a regulated activity

It was the SFO's case that Foster had established and was operating a CIS by virtue of the characteristic structures of his schemes. It did not matter how he described them, or that his schemes

concerned products that were not regulated, if the reality was that he was operating a CIS.

Concealing a material fact

A multitude of claims of financial security and stability were made, which were said to have been false and/or highly misleading. Examples of this were:

- “The scheme makes its money from gambling wins and network marketing”
- “The scheme is worth £200m in the bank”
“I’m making about £28.50 from every £1”
- “One of my networks is making me about £1.5 million a month”
- “We’ve got offices in X number of countries”
- “This scheme has got 50,000 people in it”.

It was said that these and other statements were untrue, misleading or grossly extravagant.

The defendant was ultimately sentenced at the crown court to a total of eight years for the FSMA offences, reduced by the Court of Appeal to seven years. In combination with additional counts under the Theft Act 1968, he received a total of ten years, reduced on appeal to nine.

Many early investors had in fact been paid out by the time the FSA stepped in and halted the scheme in 2004, but this was from funds paid in by later investors, who were not so fortunate. The schemes ran for three years and the £34 million came from more than 8,500 investors, some of whom lost enormous sums of money. One investor who put in £180,000 said: “I never thought that I was stupid, but I was convinced by him, and thousands of others were too.”

It could be said that the successful operation of such schemes is dependent on the greed of the participants and their absurd belief in the promises of easy and fabulous riches. But, as can be seen, the courts are not in consequence inhibited from passing heavy sentences on offenders.

Serious Economic Crime: Notes and references

Chapter 17. Serious financial crime in the financial services sector

(1) Edward Garnier QC MP, June 18, 2011.

(2) In *R v Powell and Hinkson* (2009), the appellants were convicted of offences contrary to Section 21 of the 2000 Act. On appeal, their sentences of 15 months' imprisonment were upheld. Although there was no finding of dishonesty, the sentences were held to be justified. Likewise in *R v Epton* (2009), a sentence of 15 months' imprisonment after a guilty plea was upheld.

(3) *FSA v Fradley*, The Times, December 1, 2005.

(4) Archbold 2011, 30-212.

(5) See *FSA v Fradley*.

(6) In *R v Greaves (Claude Clifford)*, *R v Jenkins (Fraser)*, *R v Botcher (Henrik)* (2010), a judge had been entitled to order that sentences imposed on three offenders for money laundering contrary to the Proceeds of Crime Act 2002 Section 328 be served consecutive to sentences imposed for conspiracy to contravene the Financial Services and Markets Act 2000 Sections 19 and 21, as the conduct involved in the money laundering offences had added to the culpability of the conduct involved in the conspiracy offences.

(7) In *FSA v Fradley*, W had been a director of a company (R), which had sent unsolicited mail to individuals inviting them to become participants in the scheme.

(8) Archbold 2011, 3-215a.

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