Feature

KEY POINTS

- The Financial Conduct Authority's Principles for Business set broader high-level standards than the detailed COBS rules.
- The COBS rules only apply the principle to act in the client's best interests to advised sales whereas, under MiFID, this principle is applicable to both advised and non-advised sales.
- Although the FCA's Principles for Business do not state explicitly that a firm must act in its client's best interests, a number of high-level principles could be interpreted as having a higher standard of care such that the best interests principle is an intrinsic component.
- This may mean that if a firm does not give the best advice, it may well be in conflict with the FCA's Principles for Business and MiFID.

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Do the FCA's Principles for Business require a firm to give the best advice?

In this article, the author considers whether the Financial Conduct Authority's high-level Principles for Business indirectly require a firm to give the best advice in order to act in a client's best interests.

BETTER OR WORSE ADVICE

A fee-paying client expects both professional and ethical standards to be met when receiving advice. A doctor would not prescribe their least effective treatment and this position should be no different in the context of the provision of financial services. There are of course different schools of thought as to what constitutes best advice, but there is also likely to be some consensus, albeit along a spectrum of possibilities.

Analogous with the concept of best advice is that of financial suitability which may appear a self-evident concept: essentially that a financial product is suitable for a customer, their circumstances, capacity for loss and risk profile, also taking account of likely future circumstances. In practice, financial suitability is harder to define. There is a risk that a financial product, which may appear suitable at the time of sale, becomes unsuitable through a design flaw, misrepresentation or an aspect of the customer's position that was not considered. A difficulty of some financial products is their long duration to maturity, as it may take a considerable time for an issue to become apparent. For example, a pension pot will have been paid into over several decades, but any failings may only be exposed once the pension is drawn, thereby potentially raising limitation and date of knowledge issues. Unsurprisingly, financial suitability is the crux of many disputes.[1]

For a clearer understanding of the Financial Conduct Authority's (FCA) intentions in respect of financial advice and suitability, it is necessary to look at the high-level principles that underpin the Markets in Financial Instruments Directive (MiFID) regulations and form the basis of the FCA's principles-based approach.

REGULATORY ORIGINS OF PRINCIPLES-BASED REGULATION

The FCA's approach to principles-based regulation originates in the changes introduced by MiFID in 2008.[2] This was formalised in their Principles for Business (PRIN) and notably in the FCA's high-level 11 business principles.[3] These principles set out broad standards that are reflected in the more detailed COBS (Conduct of Business Sourcebook), which in turn is based on MiFID – the UK COBS regulations being described as "an intelligent copy out" of these.[4]

Principles-based financial regulation follows the EU "Lamfalussy" process whereby high-level framework principles are cascaded into supranational directives, which are in turn implemented as rules by national regulators.[5] The purpose of this methodology is to ensure national regulations capture and incorporate the intentions of the high-level framework principles. The UK regulator uses these high-level principles to assist firms in understanding the outcomes the regulator wishes to see in accordance with its 11 Principles for Business and COBS rules.[6]

Under the MiFID regime complex designated investments can be only sold to retail clients on either an advised or non-advised basis. Where a sale is advised, the product must be suitable for the client. Where no advice is given the concept of appropriateness applies. These terms may initially appear semantically similar, but there are regulatory differences in terms of investor protection, for instance where a product is sold on a non-advised basis there can be no claim for defective advice.

SUITABILITY

Suitability is defined in COBS 9. In summary, a firm needs to take reasonable steps to ensure that a personal recommendation of a product sold on an advised basis is suitable for the client. This includes taking account of various factors such as the client's risk profile, knowledge, experience, financial situation, investment objectives and capacity for loss.[7] Inevitably, suitability is subjective and when a financial dispute arises an investment can be found to be unsuitable in itself as well as for the particular client (see Longmore J in *Morgan Stanley UK Group v Puglisi Cosentino* [1998] who viewed suitability in this regard as a double-barrelled concept).[8]

The origins of the suitability concept are found in Core Rule 16 of the Financial Services Act 1986.[9] Suitability itself is undefined but the consensus view is that "suitability rests somewhere between the two extremes on the spectrum running from 'not suitable' to 'positively and indisputably the most suitable available".[10] Implicit in this is the notion that "most suitable" is commensurate with "best advice", which was codified in Core Rule 17(3) of the Financial Services Act 1986. Subsequently, the explicit requirement for best advice was severed as the FCA's predecessor, the Financial Services Authority (FSA), believed that the new regulatory provisions as part of the original MiFID directives addressed this need through requirements such as the introduction of the appropriateness test in 2007.[11] The FSA's view was that the concept of best advice was an intrinsic part of the new high-level principle – that an adviser's duty is to act in a client's best interests, alternatively known as the duty of loyalty. The FSA stated:

> "we propose not to retain the obligation for advisers to recommend the 'most suitable' packaged product from the prescribed range on which they advise. We believe that the main purpose of the rule is addressed by a combination of other requirements – notably the obligation to act in the best interests of the client, requirements on disclosure, conflicts of interest, suitability itself, inducements, and the obligation that a firm must research the range it holds itself out to customers as offering."[12]

The FSA also believed the previous approach to suitability had a number of disadvantages such as the treatment of a customer's understanding of risk (which was not sufficiently addressed), and the FSA wished to clarify the responsibilities of firms undertaking financial promotions. The FSA believed there was ostensibly a mistaken view in some firms that if a particular risk was not mentioned, there was no risk to the firm that ought to have disclosed it, the belief being that it was up to the FSA to identify and explain risks to customers through standardised documentation.[13] Further, under the MiFID principles-based regulation (the introduction of high-level principles), it was the FSA's intention that firms disclosed risks to their customers in sufficient detail to enable them to make informed decisions.[14] The regulator was of the view that prior to the introduction of principles-based regulation, detailed prescribed rules had led to regulatory failures due to a "tick box" approach and a lack of holistic thinking in respect of customers. It was also the FSA's intention that principles-based regulation should mitigate the risk of asymmetry of knowledge between non-expert customers and finance firms across the board, as the high-level principles such as to communicate with due regard for the needs of the client would apply to all firms providing financial products.[15]

Although it could be presumed in relation to the duty of loyalty that acting in the client's best interests should include providing the best advice, the FSA stated advice (given in the UK) need only be sufficient after taking reasonable steps to establish suitability. Suitability allows for a range of apposite outcomes; this raises the question as to why a professional would not want to give their best advice? Potentially, one reason could be due to conflicting interests such as where the professional receives increased remuneration for selling a particular product, although the Retail Distribution Review (RDR) aimed to mitigate this by effectively aiming to ban commission payments.[16]

THE CONSEQUENCES OF BEST ADVICE/THE DUTY OF LOYALTY

For advised sales, where a firm provides investment advice under the COBS regime to a client, the investment itself as well as the advice must be suitable. However, under principles-based regulation, notably in relation to the high-level requirement to act in the customer's best interests under MiFID, by failing to give the *best* advice or recommend the *most* suitable product the investment firm may be failing in its duties. MiFID states investment firms must always "act honestly, fairly and professionally in accordance with the best interests of its clients".[17] Although the FCA Principles for Business do not state that a firm must act in its client's best interests, a number of the high-level principles could be interpreted as having a higher standard of care such as a requirement for *best* interests as an intrinsic component. Examples are the requirement to act with due skill, care and diligence (Principle 2) or to act with due regard to a customer's interests (Principle 6), or perhaps most powerfully the requirement to act with integrity (Principle 1). The *best* interests requirement explicitly exists in COBS 2.1.1 where a "firm must act honestly, fairly and professionally in accordance with the best interests of its client". In fact, this is known as the client's best interest rule, but only applies where advice is being given in the UK. The duty of loyalty or acting in the customer's best interests under MiFID is applicable in both advised and non-advised sales, whereas the UK COBS rules appear to only require this in advised sales. This apparent lack of clarity between the high-level principles and the detailed COBS rules should be interpreted by reference to the intention of the regulator in the high-level principles. In effect, the COBS rules can be seen as a "colouring in" of the outline provided by PRIN (the high-level Principles for Business).

The question of the supremacy of principles over rules as required by the Lamfalussy process has been tested in the UK in *British Bankers Association v Financial Services Authority and Financial Ombudsman Service* [2011].[18] The background to the case was the Payment Protection Insurance (PPI) scandal; in essence the British Banker's Association complained that the FCA was using its Principles of Business (PRIN) to impose obligations on banks beyond those detailed in the COBS rules, where breaches of PRIN are non-actionable. The court ruled in favour of the regulator, noting that PRIN are "the ever-present substrata to which the specific rules are added" and the principles "stand over the specific rules" and that principles are an "overarching requirement which cannot be displaced by compliance with specific rules if the overarching requirement is breached", thereby also clarifying that the "tick box" approach to compliance does not satisfy a principles-based regulatory regime.[19]

This may mean that if a firm does not provide best advice it may be in conflict with the high-level principles and MiFID. However, if a firm is selling a product on an execution only or non-advised basis does this make a difference? Complex investment products cannot be sold on an execution only basis to retail investors, the definition of which has been substantially expanded under MiFID II.[20] Where, however, products are sold on a non-advised basis, the appropriateness test would apply by imposing a duty on a firm to warn a client if it believes a transaction is inappropriate. As there may be a range of financial products that are "good enough", how this is to be reconciled with acting in a client's best interests which applies in both advised and non-advised sales under

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MiFID is unclear. This is where a professional presumably acting with integrity (as required under PRIN 1), would want their client to have the best product, and if advice were being given, the best advice. Additionally, since complex investment products may be sold without advice to customers, there may still be a duty to warn non-advised customers if they have not selected the best product.

The COBS rules can also be used to establish principles of conduct even where no statutory duty exists. HHJ Raeside took this approach in *Anderson v Openwork* [2015],[21] where she made "reference to [the COBS rules] in considering the duty to be applied".[22] The case concerned common law duties owed to a client for the sale of an unregulated financial product and in the absence of any rules, reference was made to the COBS rules to establish the appropriate standards.

The use of regulatory principles to decide whether common law tests have been satisfied is not new. Alistair Hudson in *The Law of Finance*, details several cases where financial regulatory principles have been used to interpret substantive law, noting that even guidance notes circulated by a regulator can be used to formulate principles. Alistair Hudson goes on to comment that recently courts may have erroneously overlooked regulatory principles, having focused too much on the detailed facts of a case.[23]

LACK OF PRINCIPLES: IMPLICATIONS

The regulator may take action against firms and individuals for breaches of PRIN rather than detailed COBS rules.[24] However, these principles are not actionable by private customers who must rely on the COBS rules, and most companies cannot sue for breach of statutory duty under COBS, though the consequences of the expansion of the definition of retail customers under MiFID II is as yet unclear.[25]

The implication for the supremacy of principles in regulation is that by not giving best advice a firm may not be acting in a client's best interests. As noted, there is an apparent inconsistency in the interpretation and implementation of the COBS rules in the UK. Where a non-advised sale is made, a firm may believe it has adhered to the rules via the appropriateness test, but this will not be sufficient under the MiFID regulations, which require a firm to act in a customer's best interests at all times.

If this interpretation is correct it could have consequences for redress by banks and in mis-selling litigation. To date, under the FCA Interest Rate Swaps redress programme, ordinary "vanilla" swaps have been deemed to be a reasonable replacement product, however an interest rate cap may be a more suitable product for a particular customer and it would be in a customer's best interests to provide them with the best product. Inevitability, there is likely to be some debate as to which is the best product for a client's wishes and circumstances. There is also a real risk of hindsight in disagreements about which product would have been best.

Where a product is not the best or most suitable the avenue for redress is the COBS rules for most clients, however as seen, the best interest rule does not apply in non-advised sales in the UK, and making a claim using the high-level principles is a route not open to customers. This potentially means the current COBS rules are deficient unless appeal can be made using the high-level principles of business as per *BBA v FSA* [2011]. Similarly, actions under MiFID are not open to ordinary customers leaving an unsatisfactory regulatory no-man's land. ■

1 The Financial Ombudsman Service (FOS) alone received 512,167 eligible complaints in 2014, Source FOS.
2 The FCA was previously known as the Financial Services Authority (FSA) and MiFID II came into effect in 2018.
3 https://www.handbook.fca.org.uk/handbook/PRIN/2/1.html
4 UK Practical Law, *Overview of the FSA's reform of its conduct of business regime and new Conduct of Business sourcebook (COBS)*, 7 September 2007.
5 Alexander Lamfalussy devised this approach, the methodology was adopted in wider financial regulation in the EU, see the "Lamfalussy" report: https://www.esma.europa.eu/sites/default/files/library/2015/11/lamfalussy_report.pdf.
6 Financial Services Authority, *Principles-based regulation: Focusing on the outcomes that matter* (April 2007).
7 FSA, COBS 9.2 Assessing Suitability.
8 *Morgan Stanley UK Group v Puglisi Cosentino* [1998] C.L.C 481 Q.B.D (Comm).
9 This was superseded by The Financial Services and Markets Act 2000.
10 Michael Blair, *Financial Services The New Core Rules*, 94 (1991).
11 MiFID: The EU Markets in Financial Instruments Directive was transposed into UK regulation in 2007.
12 FSA Consultation Paper No 6/19, p 77.
13 Financial Services Authority, 'Reforming Conduct of Business Regulation', CP 06/19, 19.26-27, (October 2006).
14 Ibid.
15 Ibid, 9.2. FCA,
16 Factsheet No 10 'Adviser charging' [undated]
17 MiFID, Art 19(1) and MiFID II, Art 24(1) This is also known as the general duty of loyalty, which is analogous to acting in a customer's best interests.
18 *R (on the application of the British Bankers Association) v Financial Services Authority and Financial Ombudsman Service and Nemo Personal Finance Ltd* [2011] EWHC 999 (Admin).
19 *BBA v FSA* [2011] p 162-166.
20 MiFID Art 19.
21 *David Anderson v Openwork Ltd* [2015] EW Misc B14.
22 Ibid Para 22. HHJ Raeside considered COB 5.2.5R, COB 5.3.5R and COB 5.4.3R should be taken into account in establishing the standard of the duty at para 20.
23 Alastair Hudson *The Law of Finance* (2nd Edition Sweet & Maxwell 2013) 3, 25-30.
24 PRIN 1.1.7G.
25 FSMA 2000 s 138D and FSMA 2000 (Rights of Action) Regulations, 3(1)(a).

Further Reading:

- Rethinking conduct regulation (2015) 7 JIBFL 413.
- Enforcing FSA Principles in practice (2006) 11 JIBFL 507.
- LexisNexis Financial Services blog: The FCA's business plan 2017/2018 and Mission: A clearer path ahead?