LONDON'S GLOBAL UNIVERSITY

Centre for Ethics and Law

UCL

# Duty of care and financial services

## Response to the FCA's Discussion Paper on a duty of care and potential alternative approaches

## DP18/5 July 2018

### Introduction

The UCL Centre for Ethics and Law encourages ethical reflection, awareness and positive change through teaching, research and stakeholder engagement with the public, policy makers, regulators, practitioners and academics. The centre's members are particularly interested in the relationships between ethics and the professions; law, ethics and business; innovation, technology and ethics and ethics and risk drawing on law, philosophy, psychology and practice. The Centre is sponsored by a small number of commercial organisations and the views expressed in this response are not necessarily those held by the Centre's sponsors.

We welcome the opportunity to comment on the FCA's "Discussion Paper on a duty of care and potential alternative approaches" (DP18/5). We would be happy to discuss further any of the issues raises in this response.

### Issues

It is important that the reasons are elucidated for developing and extending regulation to impose a fiduciary or duty of care on financial firms above and beyond that which currently exists to protect retail and small business customers. The debate on these aspects of regulation suggests that there are important gaps in investor protection which merit changes to the law either at the regulator's rulebook or Parliamentary level.

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Central are the concerns that:

- due to cost and time demands it is very difficult for retail and small business customers of financial institutions to successfully bring legal actions in the courts. This is particularly an issue where the amounts claimed exceed the Financial Ombudsman Services' limit,

- FCA's Principle 6 ("A firm must pay due regard to the interests of its customers and treat them fairly") and Principle 5 ("A firm must conduct its business with due skill, care and diligence") are the closest approximations to a general duty of care in the over-arching regulations. However, both the principles and specific regulatory duties may fall short in protecting financial customers due to limitations in *scope, standards* and *redress*.

- finally, the lack of a legal fiduciary or duty of care may fail to reinforce the cultural changes which lie behind, for example, the Senior Managers and Certified Persons Regime and a subject frequently mentioned to be important by regulators (eg Andrew Bailey, "Transforming culture in financial services" a speech given on 19th March 2018).[1]

This response looks at aspects of these issues in the light of the Discussion Paper and considers whether a fiduciary or duty of care should be imposed on the financial services industry.

There is a need, first, to stand back and to consider what problems the proposed solutions seek to address.

## What problems do the proposals for a new set of duties seek to address?

There are many issues with the current provision of financial services in the UK. Many may be found in retail financial markets. These include: poor quality products, products mis-sold, existing customer charged much higher fees than new customers as firms rely on customer inertia, and cross-subsidies which are significantly market distorting. However, they can be summarised as those that relate to:

- the creation and distribution of financial products
- How firms curate the products once sold. This includes issues such as the allocation of profits and losses and fees levied.

In an ideal market competition would probably resolve these issues but the financial services market is very far from this state of perfection. Nevertheless, not all markets and products share all the current list of issues. For example, highly commoditised products such as car and household insurance are now largely purchased on price with little or no advice sought or provided. This is evident in the relatively low number of complaints recorded by the Financial Ombudsman Services.[2] In these areas it is not clear that any additional duties are required or needed

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[1] https://www.fca.org.uk/news/speeches/transforming-culture-financial-services

[2] National Audit Office, "Financial services mis-selling: regulation and redress", HC 851, Session 2015-16 24, (February 2016), 16, https://www.nao.org.uk/wp-content/uploads/2016/02/Financial-services-mis-selling-regulation-and-redress.a.pdf

As mentioned earlier, poor quality financial advice has been an issue in financial services for many decades. The Retail Distribution Review (RDR) has been instrumental in largely eliminating this issue by, in practice, restricting financial advice to a relatively few high-net-worth individuals. Only some 12% of UK adults have investments of more than £10,000 and over 70% have no investments whatsoever.[3] This translates to about 14.6m UK adults having any investment product.[4] However, it should be noted that the FCA and HM Treasury "Financial Advice Market Review – Baseline Report" issued in June 2017 gives a much more upbeat view.[5] It is certainly, true that since RDR there has been a significant decrease in FCA Enforcement action for mis-selling financial products.[6] However, it is worth noting that the National Audit Office review report issued in 2016 indicated that "the FCA lacks good evidence on whether its actions are reducing overall levels of mis-selling." [7]

Consequently, based on limited data, there is not so much an imbalance in information available on products for consumers but more likely an imbalance in interest and attention on the part of consumers. While financial services firms remain focused consumers remain much less diligent when it comes to financial services products and services demonstrating a general lack of engagement.[8] The perception is of a large population with basic, largely commoditised, financial products, such as bank accounts and motor insurance, and a small minority owning a financial asset. Consequently, the debate about esoteric issues such as fiduciary duties or duties of care passes by the vast majority of citizens. In summary, most people are financially 'disengaged' relying on commoditised products to meet basic needs while much of financial services regulation remains concerned with a few relatively well-off consumers.

## Asset management

Of particular concern to the latter is the investment management industry. John Kay in his report, inter alia, recommended that "all participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers." [9] However, the term "fiduciary duty"

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[3] Financial Conduct Authority, The financial lives of consumers across the UK 2017 Review, 70, https://www.fca.org.uk/publication/research/financial-lives-consumers-across-uk.pdf

[4] Ibid, 177

[5] FCA and HM Treasury, "Financial advice market review – baseline report, (June 2017), https://www.fca.org.uk/publication/research/famr-baseline-report.pdf

[6] FCA, "Enforcement annual performance report 2017/18", 6, https://www.fca.org.uk/publication/corporate/annual-report-2017-18-enforcement-performance.pdf, which indicated only two closed mis-selling cases in 2017/8 out of 208 (less than 1%) compared to seven in 2016/7 out of 115 (6%). Earlier FCA reports do not provide sufficient information to make a similar analysis

[7] Supra n2, (NAO report), 8

[8] Supra n3 (Financial lives), 10

[9] John Kay, 'The Kay review of UK equity markets and long-term decision making: Final Report, (2012), 13, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

may have been mis-interpreted to something closer to a duty of care rather than the more onerous requirements imposed under general law.[10] It is questionable whether a business operating under financial services regulations and in accordance with, say, s172 of the Companies Act 2006 with a duty to promote the success of the company and the need to have regard to a number of other interests could work to the strict definition of a fiduciary duty.

## Why general law duties are of little help

It is very unlikely that imposing increased duties of care or a fiduciary duty will bring clarity in the legal expectations of financial services providers' behaviour, or indeed substantially change behaviour. We are publishing a detailed academic paper to explain the incompatibility of the 'duty of care' and 'fiduciary duty' under general law with the needs that have been articulated in the Consultation paper.

The common law duty of care has been largely interpreted to the same standard as regulatory duties in many cases, such as the standard of suitability for investment advice and appropriateness for other transactions. Where no regulatory duty is attracted, in execution-only transactions, the common law duty of care is also frequently also excluded as its elements of 'assumption of responsibility' and 'reliance' cannot be established. The common law duty of care is increasingly raised as a fall-back action where regulatory duties do not apply, and have rarely been of any help to claimants. The perception that the common law duty of care would somehow fill the gaps of protection left by regulatory duties is misplaced, and this role is often played by the 'Treating Customers Fairly' principle instead.

One may query whether 'fiduciary' duties import of a more exacting standard that can raise the standards of the current regulatory regime. A fiduciary duty has been described a "duty of loyalty"[11] and it includes preventing the fiduciary obtaining any unauthorised benefit as a result of their position or allowing any personal or other benefit to conflict with their duty. [12] Central to all of this is the existence of "trust": trust is bestowed upon and accepted by the fiduciary.

Deterrence is the most likely reason for seeking to impose a fiduciary duty since it sets a very high standard of conduct which, in practice, may overwhelm any commercial business model. However given the realities of the financial intermediation business, the 'fiduciary' duty in finance only arises in specified situations and can be modified by contractual terms and regulatory rules.

In the retail financial services market the customer places trust in the financial institution and its representatives. However, there may be a misunderstanding between the parties. The financial

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[10] Single-minded loyalty as required under general law such as Bristol v Mothew… Department for Business, Innovation and Skills 'Response to the Kay Report', (November 2012), 9, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253457/bis-12-1188-equity-markets-support-growth-response-to-kay-review.pdf

[11] Remus Valsan, 'Fiduciary duties, conflict of interest, and proper exercise of judgement', (2016) 62:1 McGill Law Journal, 1, 10

[12] Lord Justice Millett noted in *Bristol and West Building Society v Mothew,* [1996] EWCA Civ 533, http://www.bailii.org/ew/cases/EWCA/Civ/1996/533.html

institution may accept that has to provide a certain level responsibilities: operate the bank account competently, keep proper account of the transaction, execute the insurance contract etc. However, these may not coincide with the expectations of the customer. The latter may see the financial services business as subject to a much higher duty - as a keeper of their trust. However, English law is reluctant to class day to day engagements as giving rise to a fiduciary duty. Incompetence does not equate to a breach of any duty of loyalty.[13] Financial services regulation, for public policy reasons, seeks to bridge and, in many ways, mitigate this disjunct in perceptions.

The issue is more pertinent with the increased democratisation of finance with a broader range of people having access to financial products. The creation of a stricter fiduciary relationship in their day to day dealing between customers and their financial firms could have consequences in public policy terms. Financial businesses could limit the access to financial advice and products to those where the profit, cost and risk ratios were more favourable.

## Culture, ethics and internalisation of good behaviour in firms is more important

All the evidence points to the need to continue the process of improving the culture and ethics of financial firms. This includes improved governance and risk management. However, even more important is who the firms seek to recruit, how they are inducted into the firm and trained and supervised. Critical to success is the measurement of success and recognition within the firm including target setting and remuneration policies and practices. This has been clearly identified by the recent Australian Royal Commission Interim Report on misconduct in banking and financial services.[14] "An employee will treat as important what the employee believes that the employer generally, or the employee's supervisors and peers, treat as important. When the employee and others in the organisation, including the employee's supervisors and peers, are remunerated according to …how much revenue or profit they contribute to the entity, sales or revenue and profit are treated as the goal to pursue. How the goal is pursued is treated as a matter of lesser importance."[15]

Similarly, regulated firms watch closely what the regulator does and will deem important whatever they see the regulator actively doing. Consequently, there needs to be intense supervisory activity and enforcement action and this needs to be very apparent as a communication means to the industry and more widely.

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[13] Incompetence is "not a breach of a fiduciary duty of loyalty; it is simply the breach of a duty of care", Lord Walker, *Hilton v Barker Booth and Eastwood* [2005] UKHL 8 at para 29

[14] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry - Interim Report, (2018) Volume 1, https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf

[15] Ibid, 302

## Improving poor culture and behaviour

As identified by Sharon Gilad in her empirical research, firms, generally, have a considerable ability to self-justify and to rationalise their actions. It is likely that any new duty imposed upon them will go the same way as the "treating customers fairly" (TCF) initiative. Her work found that in many regulated firms: "management communication of TCF messages through posters and training programs were cynical attempts at 'cosmetic compliance' – posters appeared just before a visit from the regulator, and internal communications were …focused on providing the regulator with superficial evidence of 'cultural transformation.'" [16] The research found that changes in regulation would not be "internalised" within an organisation and that existing practices and cultures would "diverge from the ideal preferences of managers and from the expectations of regulators and external stakeholders."[17] The central issue is the need to persuade regulated firms to reflect and to analyse their business model, their approach to corporate governance, risk management etc and who they recruit, train etc and their management style, targeting and remuneration.

It is also questionable whether imposing a duty of care on firms and advisors would significantly improve customer protection. The Law Commission has stated that "fiduciary duties consider the motive or the purpose of a decision, while duties of care guard against carelessness and incompetence".[18] The current FCA Principles of Business require regulated firms to:

- conduct its business with integrity,
- conduct its business with due skill, care and diligence,
- pay due regard to the interests of its customers and treat them fairly,
- manage conflicts of interest fairly, both between itself and its customers and between a customer and another client,
- take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.[19]

Principles can be utilised in enforcement actions in cases where specific regulatory duties are not attracted but sharp conduct on the part of financial firms has been carried out to the detriment of customers. There is no real justification for the perception that the Principles are certainly weaker in their demands than 'duties'. However, the empirical work by Gilad found that there was a significant disjunct between what regulated firms did and the regulatory expectation when applying the need to comply with Principle to "treat customers fairly".[20] "Managers' perceptions were associated with firm-specific cognitive

[16] Christine Parker and Sharon Gilad, 'Internal corporate compliance management systems: structure, culture and agency" in Christine Parker and Vibeke Lehmann Nielsen, *Explaining compliance: business responses to regulation*, (Edward Elgar, 2012), 185

[17] Ibid, 185

[18] Law Commission Consultation Paper 215 (Oct 2013), 6.34 http://www.lawcom.gov.uk/app/uploads/2015/03/cp215_fiduciary_duties.pdf

[19] FCA Principles of Business, https://www.handbook.fca.org.uk/handbook/PRIN.pdf

[20] Gilad, Sharon Gilad, 'Institutionalizing fairness in financial markets: mission impossible?', (2011) Regulation and Governance, 5(3), 309–332, 315

frames regarding their organisations attributes (e.g. successful, doing the right thing for customers, being a customer champion, etc.)." [21] They saw their firms as automatically compliant and their perception was that this Principle applied "to other firms, but not to their".[22] There is scope to consider if the Principles ought to be tightened further, perhaps along the lines of 'best interests of customers', akin to the Australian regulatory duty imposed for investment advisers. We discuss this in detail in our paper.

## FCA Questions

**Question 1**

**Do you believe there is a gap in the FCA's existing regulatory framework that could be addressed by introducing a New Duty, whether through a duty of care or other change(s)?**

For the reasons given in the body of this response it is unlikely that imposing substantially increased duties of care or a fiduciary duty will significantly change behaviour.

However, there are gaps in the regulatory framework that require specific thinking about policy choices. One, in terms of scope of protection, there are gaps. For example, consumers are not protected in execution-only transactions, and if customers are classified as non-retail (even borderline, like small businesses) then their scope of protection is narrow and often excluded. Specific thinking can be directed to reforming the scope of protection. Second, we do believe that regulatory standards can be raised. For example the Australian duty of best interests is a combined duty of general and specific enunciations that go beyond the advisory duty here. We also think the Principles could be tightened. For example, the Principle requiring regulated firms to pay "due regard to the interests of its customer" sets a lower threshold. A revised Principle could require the firm to "prioritise the interests of their customer above all others". This would set a clearer regulatory expectation of the standard to be reached. Moreover, empirical work indicates a significant disjunct between what regulated firms do and regulatory expectations. In part, this could be because some managers perceived their firms as automatically compliant with no need to change. Finally there can be improvements in facilitating redress for consumers, see below.

**Question 2**

**What might a New Duty for firms in financial services do to enhance positive behaviour and conduct from firms in the financial services market, and incentivise good consumer outcomes?**

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[21] Ibid

[22] Ibid

We argue for specific thinking in relation to the scope of protection and the level of protection in key service contexts eg advice. These are not merely achieved by the 'duty of care'. The overall Principles can however benefit from improvement as we suggest above.

**Question 3**

**How would a New Duty increase our effectiveness in preventing and tackling harm and achieving good outcomes for consumers? Do you believe that the way we regulate results in a gap that a New Duty would address?**

Specific duties do more in preventing harm or affecting ex ante conduct than general duties, as empirical research suggests. So if the point is preventing harm, specific regulatory duties and their elevation in particular service contexts is a more pertinent line of inquiry. Empirical research has also identified scope for managers of regulated firms to reassure themselves that all is right. The objective should be to encourage them to reassess what they think and do and to build an ethical culture at firms.
On correlating duties with financial outcomes, this is difficult as financial outcomes are outworkings of a risk/return tradeoff. If the policy choice is to shape a good decision context at point of sale, then regulatory duties can only focus on conduct at that point (transactional narrative in law). If there is consideration for post-sale regulatory interventions that may adjust risk or loss distribution, then thinking is to be directed to measures such as debt relief, adjustment of loss/risk, rewriting of contracts etc (social/distributive narrative in law).

**Question 4**

**Should the FCA reconsider whether breaches of the Principles should give rise to a private right for damages in court? Or should breaching a New Duty give this right?**

We see the regulators, with their extensive powers, as the primary means for protecting financial service stakeholders and for arranging redress processes if appropriate. In this light regulatory enforcement should more frequently be coupled with compensation or restitution orders under s384, FSMA. Processes should be instituted to facilitate consumer redress through coupling with successful enforcement, such as carried out by the US CFPB. Redress procedures implemented by firms such as consumer redress schemes should be monitored so that consumers are treated properly. There should also be easier access by a wider range of persons to the Ombudsman for individual redress, bearing in mind that the court recognises the final nature of Ombudsman orders.

**Question 5**

**Do you believe that a New Duty would be more effective in preventing harm and would therefore mean that redress would need to be relied on less?**

Empirical research generally finds that specific regulatory duties are more effective in shaping ex ante behaviour at firms. However, a view can be taken that general duties, which tend to be 'fuzzier' and compel firms to be more circumspect in their behaviour, would instil behavioural change too. In our paper we opine that a combination of the two would be optimal. Enforcement and redress are always important as regulatory duties cannot guarantee zero misconduct, and there is scope for improving those.