Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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Incorporating a Duty of Care into the Financial Services & Markets Act

Summary

The financial services industry has a long and ignoble history of poor treatment of consumers, as evidenced by numerous mis-selling scandals, the bad practices regularly discovered by the FCA, and the hundreds of thousands of complaints the Financial Ombudsman upholds in favour of consumers every year. The most recent example is foreign exchange rigging, which saw banks fined £4 billion for deliberately misleading their customers. Fixing the market was still happening a full five years after the financial crisis, at a time when banks were protesting loudly that they had cleaned up their act.

Clearly the law does not protect customers of financial services firms as it should. Massive fines do not appear to have any significant impact on firms' behaviour, but they do add to costs for consumers.

The Financial Services Consumer Panel proposes that the Financial Services & Markets Act (FSMA) should be amended to require the Financial Conduct Authority (FCA), as part of its consumer protection objective, to make rules specifying what constitutes a reasonable duty of care that financial services providers should exercise towards their customers.

Whilst falling short of a full fiduciary duty, a duty of care would oblige providers of financial services to avoid conflicts of interest and act with the best interests of the customer in mind. The Panel envisages that the FCA rules on a duty of care would take account of both the complexity and risk of the product or service being offered, and the level of financial knowledge and understanding of the customer.

The proposed duty would not affect the broad definition of 'consumer' in FSMA, so would apply to both wholesale and retail business. However, the primary intention would be to protect retail and smaller business customers. Accordingly, the Panel envisages that the FCA's rules would be most stringent for, for example, investment products offered to retail consumers, or complex hedging products aimed at small businesses.

The Panel believes a statutory duty of care is necessary because the current regulatory approach of ensuring firms 'treat customers fairly' enshrines a weak duty to the consumer, and is arguably rendered ineffective by FSMA, which also requires the FCA to have regard to the 'general principle that consumers should take responsibility for their decisions'. The 'consumer responsibility' principle fails to take into account the imbalance in power between firms and their customers, information asymmetries, and low levels of consumer financial capability. Accordingly, the Panel believes consumers can only reasonably be expected to take responsibility for their decisions where firms have exercised a duty of care, in line with FCA rules.

The Panel believes that its proposed amendment to FSMA would engender long-term cultural change in financial services providers, acting as a preventative measure to stop future mis-selling and other poor behaviour. A duty of care could also help the Financial Ombudsman Service (FOS) decide what is fair and reasonable, and, as a measure of last resort, confer on consumers a statutory right to pursue damages for negligent firm behaviour through the courts. It would bring much-needed clarity to the rules governing the relationship between firms and their customers.

The Panel recommends that the Government should find an appropriate legislative vehicle to put the Panel's draft clauses to Parliament.

What is a duty of care?

The concept of a duty of care covers relationships where one person acts on behalf of, or for the benefit of, another with a discretion or power that affects the interests of the other. In a financial services context, this means:

- no conflict of interest;
- no profit at the expense of the customer without their knowledge and consent;
- loyalty to the customer; and
- a duty of confidentiality, preventing firms from taking advantage of information gained from the customer.

The duty of care would cover both direct customer-firm relationships, and also more complex or indirect relationships, for example where an investment fund manager had no direct interaction with an individual consumer, but acted for their benefit. This is based on the law of negligence, which is applicable where there is a *sufficient* relationship between the parties.

The Panel is not proposing that a full fiduciary duty should govern the relationship between regulated firms and their customers. This would impose an obligation to act in the best interest of customers to the exclusion of the firm's own interests and those of third parties, including shareholders.

The Panel therefore proposes a lesser duty on the firm: to act with reasonable care towards the customer to ensure that the customer does not suffer unreasonable harm or loss. There are numerous examples of judicially-recognised duties of care of this kind (including solicitor-client, employer-employee, doctor-patient and manufacturer-consumer) and in the Panel's view it is anomalous that one does not apply to the relationship between a financial services firm and its customers.

The Panel envisages that the FCA's rules on duty of care would, for example, require firms to ascertain whether the potential customer has understood the features, risks and costs of a product or service prior to sale.

A duty of care would be flexible, and allow the FCA to tailor the regulatory approach 'as appropriate' to reflect the business being undertaken. This would allow a 'limited' duty of care to be applied, say, to execution-only retail services such as non-advised sales of regulated products, or to wholesale business.

Why is a duty of care needed in FSMA?

Balancing the Consumer Responsibility Principle

The FCA must secure an appropriate degree of protection for consumers of regulated activities[1]. However, section 1C(2)(d) of FSMA specifies that the FCA must have regard to 'the general principle that consumers should take responsibility for their decisions'.

The financial services industry has argued that a duty of care would remove responsibility from customers, and "create a situation where they no longer have any motivation to behave responsibly".[2] The Panel strongly disputes this. The industry has offered no evidence that a duty of care would incentivise consumers to behave irresponsibly.

Moreover, under the law consumers are under no legal obligation other than to act honestly. As a result, the precise extent of 'consumer responsibility' is not defined anywhere, which renders the principle ambiguous and likely to be interpreted very differently by firms and consumers. The Panel also notes that, where a customer has acted dishonestly in dealing with a firm the latter is already protected against claims for compensation, for example under the Consumer Insurance (Disclosure and Representations) Act 2012.[3]

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[1] https://fshandbook.info/FS/glossary-html/handbook/Glossary/R?definition=G974
[2] For example, HSBC's evidence to Parliament on the Financial Services Bill:
http://www.publications.parliament.uk/pa/cm201212/cmpublic/financialservices/memo/fs11.htm.
[3] This Act applies only to retail consumers.

Research[4] carried out on behalf of the FCA's Practioner Panel in 2013 concluded that retail consumers are willing to take on responsibility when buying financial products or services. However, the research also clearly underlined the barriers consumers face in making informed choices. These included inappropriate remuneration structures that incentivise mis-selling; increased product complexity and excessive disclosure of information, for example, through 'one-sided and impenetrable' terms and conditions.

It is therefore clear that a significant shift in firms' behaviour, by acting in the consumer's best interest, needs to occur before individuals can be expected to exercise full responsibility. Baroness Hale, Deputy President of the Supreme Court of the United Kingdom, put it succinctly: "Consumer law in this country aims to give the consumer an informed choice rather than to protect the consumer from making an unwise choice."[5]

The Panel's contention is that unless firms observe a duty of care towards their customers, the consumer is unable to make an informed choice in the first place.

The complexity of many financial services, combined with weak standards of governance and asymmetries of information and power between consumers and providers, have resulted in an extremely unbalanced relationship. The 'consumer responsibility' principle needs therefore to be balanced by introducing a statutory duty of care.

The idea of balancing the consumer responsibility principle with greater firm responsibility is not new. Parliament's Joint Committee on the Financial Services Bill recommended in 2011 that a "statutory duty should be placed on firms to treat their customers 'honestly, fairly and professionally'", allowing the FCA ensure that "companies address conflicts of interest and provide intelligible information, rather than accurate but impenetrable information that leaves customers confused"[6].

This concept was welcomed by the then-Financial Services Authority (FSA), which stated that it would "welcome a general principle that a regulated firm should act 'honestly, fairly and professionally' in accordance with the best interests of its consumer when carrying on regulated activities with or for that consumer."[7]

Given the consistently low levels of financial capability in the UK[8], the consumer responsibility principle places consumers at a disadvantage. The starting point should be that consumers can only take responsibility for their decisions where the firm has exercised a duty of care. Such an obligation would not incentivise consumers to behave irresponsibly, but simply ensure that firms act with their customers' best interests in mind. The introduction of a duty of care would bring much-needed clarity to the rules governing the relationship between firms and their customers.

Addressing inadequate levels of care towards customers

The industry has also relied on Part 1A of FSMA, as amended by the Financial Services Act 2012, to argue that a duty of care would not offer any additional level of consumer protection.[9] Part 1A requires the FCA to 'have regard to (…) the general principle that those providing regulated financial services should be expected to provide consumers with a level of care that is appropriate'.

Although the Government argued at the time of the passage of the Financial Services Bill 2012 through Parliament that this provision would ensure "fairness, honesty and professionalism", it is clear that this intended effect has not been achieved in practice.

Repeated mis-selling scandals, including personal pension products[10], payment protection insurance[11] and, more recently, interest rate hedging products for small businesses[12] and forex

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[4] http://www.fs-pp.org.uk/documents/fca_practitioner_panel_consumer_responsibility_report_september_2013.pdf#page=10n
[5] http://www.bailii.org/uk/cases/UKSC/2009/6.html
[6] http://www.publications.parliament.uk/pa/jt201012/jtselect/jtdraftfin/236/236.pdf
[7] http://www.parliament.uk/documents/joint-committees/Draft-Financial-Services-Bill/WEBWRITTENEVIDENCE.pdf#page=644
[8] See, for example, the Financial Inclusion Commission's final report of March 2015: http://www.financialinclusioncommission.org.uk/pdfs/fic_report_2015.pdf
[9] For example, the evidence offered by the British Bankers' Association to the Public Bill Committee on the 2012 Financial Services Bill: http://www.publications.parliament.uk/pa/cm201212/cmpublic/financialservices/memo/fs08.htm
[10] Compensation for miss-sold personal pensions totaled £12 billion in 2002 (FSA press notice PN/070/2002, 27 June 2002).
[11] As of June 2015, redress for miss-sold payment protection insurance policies was £24.3 billion: http://www.fca.org.uk/news/fca-to-gather-evidence-on-how-the-ppi-complaints-process-is-working.
[12] As of May 2015, small firms have received nearly £2 billion in compensation for miss-sold IRHPs: http://www.fca.org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products

rigging[13], have shown that the financial services industry has frequently sold inappropriate products on an industrial scale to customers who were later revealed not to have been properly informed of the risks involved, or, in some cases, were entirely unaware they had purchased the product at all.

Part 1A of FSMA is therefore not an adequate substitute for a statutory duty of care. It does not create a requirement for firms to act with their customers' best interests in mind, nor to eliminate conflicts of interest. Indeed, it is clear that firms do not deliver even an 'appropriate' level of care, and clearer FCA rules are needed to ensure that the industry acts in the best interest of its customers.

Strengthening 'Treating Customers Fairly'

A duty of care would go beyond the current FSMA requirement for the FCA to have regard to the general principle that those providing regulated financial services should provide a "level of care appropriate to the consumer involved or transaction being undertaken".

This requirement has been implemented through the FCA's Treating Customers Fairly ('TCF') initiative. This requires a firm to 'pay due regard to the interests of its customers and treat them fairly'. This approach has failed to tackle a number of market problems leading to poor consumer outcomes. It appears that firms are frequently fulfilling their TCF obligations through increasing amounts of disclosure documentation, which is in many cases not comprehensible for consumers.

Given that a requirement to 'pay due regard' to a customer's interest is a lower standard than a requirement to put the interests of the customer first, TCF has failed to tackle fundamental consumer protection issues, such as the conflicts of interest inherent in the business models of many financial services firms. Moreover, as a principle rather than a FCA rule, consumers cannot rely on it in court.

What would a duty of care change in practice?

A duty of care would oblige firms to have act in the best interest of their customers, and to avoid conflicts of interest that may be detrimental to them. Firms would have to ensure, for example, that their customers understood the information they were given about a product or service before a sale took place. This goes beyond the existing regulatory protections afforded to consumers.

This in turn would be a significant help in bringing about the kind of cultural change that the financial services industry says it wants. The proposed reforms are also consistent with efforts elsewhere to restore trust in the financial services industry, including the creation of the new Banking Standards Review Council[14] and the Investment Association's "Statement of Principles"[15].

Moreover, the cultural change needed for firms to start acting in the consumer's best interest is also in the long-term interests of the industry itself, as it would act as a preventative measure to stop future mis-selling scandals from occurring and obviating the need for financial penalties and lengthy redress mechanisms. This also benefits firms from a prudential perspective: compensation for the PPI scandal now totals £24.3 billion, while penalties for forex rigging exceed £6 billion. The cultural shift the new rules would require will also serve to protect capital reserves from being depleted by future fines or demands for compensation.

Any FCA action for a breach of its duty of care rules would be without prejudice to the right of the affected consumer to seek redress through the FOS and, ultimately, the courts.

The Panel expects that a duty of care would assist the FOS by clarifying through the FCA rulebook what constitutes proper behaviour by firms towards their retail and microbusiness customers. New rules on duty of care would in practice act as a benchmark for firm behaviour that the Ombudsman could use when making its 'fair and reasonable' determination in individual cases of whether a firm acted properly in relation to a consumer. Moreover, the anticipated culture change in firms should also lead to an overall reduction in complaints and thus the FOS's workload.

[13] http://www.fca.org.uk/news/fca-fines-five-banks-for-fx-failings
[14] http://www.bankingstandardsboard.org.uk/bsrc-proposals/
[15] http://www.theinvestmentassociation.org/assets/files/press/2015/20150428-statementofprinciples.pdf

Finally, a legal duty of care would give the customer the right to claim damages from the financial services provider. The amendment would allow consumers to seek compensation for losses arising from a breach of any FCA rule relating to the duty that amounts to negligence under section 138D of the Financial Services Act 2012. This would be a significant departure from the current situation: the FCA principle of 'Treating Customers Fairly' is not a rule, and can therefore not be relied upon by a consumer seeking redress in court.

Does a duty of care already exist?

Although there is no explicit duty of care across financial sectors, several measures in place have, or will have, a similar effect. The Retail Distribution Review (RDR), for example, aimed to ensure the interests of financial advisers and their customers are aligned by obliging an advisory firm to act "honestly, fairly and professionally in accordance with the best interests of its client". A consumer can already rely on a breach of this rule if suing for damages in court.

In this way, the RDR has eliminated in the adviser sector the conflicts of interest that persist in other parts of the financial services industry. The Panel would like to see this principle extended to all regulated activities under FSMA.

European legislation is also relevant. The Markets in Financial Instruments Directive[16] (MiFID 2), the Mortgage Credit Directive[17] (MCD) and the new Insurance Distribution Directive[18] (IDD) contain provisions that oblige firms to act 'honestly, fairly and professionally', taking account of the rights and interests of consumers. MiFID 2 and the IDD also require firms to establish policies to prevent and manage conflicts of interest. A general duty of care has also recently been introduced in the Netherlands.[19]

These Directives provide a legal principle governing relationships between firms and their customers for firms providing asset management, mortgages and insurance mediation, irrespective of any further action at UK level. The Panel believes that it is in the best interest of consumers that they can enjoy the same high standards of conduct from firms across the financial services spectrum, and in the interests of firms to have legal clarity.

[16] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0065
[17] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0017&from=EN
[18] Still under negotiation, but included in article 15 of the European Parliament first reading position.
[19] http://wetten.overheid.nl/BWBR0020368/4/Hoofdstuk42/Afdeling423/Artikel424a/geldigheidsdatum_01-06-2015

The Panel’s amendment

Full text of the amendment

Amendments of Financial Services and Markets Act 2000

(1) In section 1C(2) add the following at the end of paragraph (e) –

“, having regard to the general duty to provide those services honestly, fairly and professionally in accordance with the best interests of the consumers in question.”

(2) In section 3B(1) of the Financial Services and Markets Act 2000 after paragraph (h) insert –

“(i) the principle that, where appropriate, authorised persons should act honestly, fairly and professionally in accordance with the best interests of consumers who are their clients;”

“(j) the principle that, where appropriate, authorised persons should manage conflicts of interest fairly, both between itself and its clients and between clients”

Annex: Consolidated version of FSMA if amended as proposed

The Panel's proposed changes are highlighted in bold underline

"Section 1C: The consumer protection objective

(1) The consumer protection objective is: securing an appropriate degree of protection for consumers.

(2) In considering what degree of protection for consumers may be appropriate, the FCA must have regard to—

(…)

(e) the general principle that those providing regulated financial services should be expected to provide consumers with a level of care that is appropriate having regard to the degree of risk involved in relation to the investment or other transaction and the capabilities of the consumers in question, **<u>having regard to the general duty to provide those services honestly, fairly and professionally in accordance with the best interests of the consumers in question</u>**;

(…)

Section 1B: The FCA's general duties

(…)

(5) In discharging its general functions the FCA must have regard to—

(a) the regulatory principles in section 3B;

(…)

Section 3B: Regulatory principles to be applied by both regulators

(1) In relation to the regulators, the regulatory principles referred to in section 1B(5)(a) and 2H(1)(a) are as follows—

(…)

<u>*(i)* the principle that, where appropriate, authorised persons should act honestly, fairly and professionally in accordance with the best interests of consumers who are their clients;</u>

<u>*(j)* the principle that, where appropriate, authorised persons should manage conflicts of interest fairly, both between itself and its clients and between clients.</u>"