MIS-SELLING OF OVER-THE-COUNTER DERIVATIVES: A CALL FOR MORE HAMORNIZED INTERPLAY BETWEEN PRIVATE LAW AND FINANCIAL REGULATION

by

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ABSTRACT

Disputes over the “mis-selling” of over-the-counter derivatives took place in countries with sophisticated financial market such as the US and the UK from 1990s, but the recent global financial crisis revealed the problem of “mis-selling” of over-the-counter derivatives wide-spread in many jurisdictions. In the UK, ”mis-selling” of interest rate hedging products was a social scandal aftermath of the crisis. In pursuit of effective regulation of “mis-selling” of over-the-counter derivatives, this thesis addresses three research questions.

The first research question is why transactions of over-the-counter derivatives are prone to “mis-selling” practices. The thesis explains that the vulnerability of over-the-counter derivatives to “mis-selling” is caused by dependence of consumers on financial institutions due to asymmetric information and knowledge, high profitability of selling over-the-counter derivatives and the expanding products and consumer base of over-the-counter derivatives.

The second question is how social institutions such as statutory regulation and private law have dealt with “mis-selling” of over-the-counter derivatives. The thesis shows that statutory regulation demands that financial institutions assume fiduciary duties which cannot be denied or modified by contracts while private law sees an over-the-counter derivative transaction between a consumer and a financial institution as just one of the commercial contracts between equal counterparties. It also explains the difference of the two institutions in testing causality between breach of standards and loss.

The third research question is how to achieve harmonized interplay between private law and statutory regulation in regulating “mis-selling” of over-the-counter derivatives. The thesis proposes two legal reforms; the statutory “right of action” for breach of regulatory requirements, which is now entitled only to private persons, should be extended to all consumers except for financial institutions; the causation test in private law should be relaxed to the ‘significance’ test.

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LIST OF ABBREIVATIONS

CESR	Committee of European Securities Regulators
COB	Conduct of Business Sourcebook
COBS	Conduct of Business Sourcebook
Core Rules	Core Conduct of Business Rules
CPR 2014	Consumer Protection Amendment Regulations 2014
CSI	Credit Suisse International
CSUK	Credit Suisse UK Limited
DTI	Department of Trade and Industry
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Scheme
FSA 1986	Financial Services Act 1986
FSA 2010	Financial Services Act 2010
FSA 2012	Financial Services Act 2012
FSA	Financial Services Authority
FSMA 2000	Financial Services Market Act 2000
ISDA	International Swaps Derivatives Association
LSTB	Lloyds TSB Bank
MiFID	Markets in Financial Instruments Directive
PCBS	Parliamentary Commission on Banking Standards
PFI Act	Prevention of Fraud Investment Act
RBS	Royal Bank of Scotland
SFA	Securities and Futures Authority
SIB	Securities and Investments Board Ltd.
SRO	Self-Regulatory Organization
TCF	Treating Customers Fairly
Titan	Titan Steel Wheel
JPMIB	JP Morgan International Bank
IRHPs	Interest Rate Hedging Products
PRA	Prudential Regulatory Authority
SCARPs	Structured Capital-At-Risk investment Products

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I. INTRODUCTION

1.1 Background

The global financial crisis, which is considered to have been the worst crisis since the Great Depression of the 1930s, had a huge impact not only on the financial market but also on the whole global economy.[1] Derivatives, more specifically over-the-counter derivatives, are believed by many commentators to have transformed what was a bubble in part of the US housing market into global catastrophic shock.[2] Considering the role played by over-the-counter derivatives in the global financial crisis, it is not surprising that there have been so much research about the systemic risk caused by over-the-counter derivatives.[3]

Another aspect of over-the-counter derivatives revealed by the global financial crisis was abusive sales practice by dealer financial institutions. Macro-economic indicators such as currency exchange rates and interest rates, which are main underlying references of over-the-counter derivatives, experienced great volatility during and in the aftermath of the crisis, and this resulted in unexpected and huge losses in over-the-counter derivatives that end-users had entered into. Many of those end-users have argued that they were misled by financial institutions into entering into the over-the-counter derivatives. In the UK, interest rate hedging products ("IRHPs") which are one type of over-the-counter derivatives, resulted in extensive financial losses of many SMEs that had entered into these products.[4]

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[1] See eg European Commission International Market and Services, 'Towards more responsibility and competitiveness in the European financial sector' (European Union, 2010), <http://ec.europa.eu/internal_market/finances/docs/leaflet/financial_services_en.pdf> accessed 10 June 2016

[2] Colleen M Baker, 'Regulating the invisible: the case of over-the-counter derivatives' (2009) 85 Notre Dame L. Rev. 1287, 1349; Christopher Whalen, 'Yield to Commission: Is an OTC Market Model to Blame for Growing Systemic Risk?' (2008) 14.2 Journal of Structured Finance 8, 11

[3] See eg U.S. Treasury, *Financial regulatory reform: a new foundation* (2009)

[4] Financial Services Authority, 'Interest Rate Hedging Products Pilot Findings' (2013)

Some brought their cases to the courts to be compensated for their losses from IRHPs.[5] At the same time, the financial regulator reviewed the sales practice of IRHPs and arranged for compensation to be paid to some eligible end-users.[6] However, despite some land-mark rulings from the courts and a regulator-led programme of compensation, still some SMEs brought or appealed their cases to the courts and applied for judicial review[7] of the regulatory compensation process.[8]

Disputes over "mis-selling" of over-the-counter derivatives have taken place in many jurisdictions other than the UK. The International Monetary Fund reported that 50,000 non-financial firms from 12 different countries including Japan, South Korea, Hong Kong, China, Brazil, etc. suffered significant losses from currency-based over-the-counter derivatives during the global financial crisis.[9] And these disputes are not new. During the 1990s in the US, "mis-selling" disputes on over-the-counter derivatives started to become a matter of public concern, which involved the Californian District Government of Orange County, Procter & Gamble and many other private and public entities.[10] In the UK, from the 1990s, disputes over "mis-selling" of over-the-counter derivatives continued to occur and were brought to the courts even though they did not attract public attention like in the US.[11] Such continued and wide-spread occurrence of disputes over "mis-selling" of over-the-counter derivatives show that they are not just one-off issues in particular

[5] See n482, n484, n485, n486 and n487
[6] Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' (2012)
[7] *R (Holmcroft Properties Ltd) v KPMG* [2016] EWHC 323 (Admin)
[8] See <http://www.bully-banks.co.uk/news/> accessed 15 May 2015
[9] Randall Dodd, 'IMF Working Paper: Exotic derivatives losses in emerging markets: questions of suitability, concerns for stability' (2009) 3, <http://financialpolicy. org/kiko. pdf> accessed 17 November 2014
[10] United Sates Congress Committee on Banking, Finance and Urban Affairs, *H.R. 4503,* 'The Derivatives Safety and Soundness Supervision Act of 1994 : hearing before the Committee on Banking, Finance, and Urban Affairs, House of Representatives, One Hundred Third Congress second session' (1994), *<https://archive.org/details/hr4503derivative00unit> accessed on 10th June 2015*
[11] See Table 2 at 107

geographic areas or periods of time but that there can be structural causes in the markets and in the social institutions that are often assumed counter and regulate "mis-selling".

1.2 Research questions

The thesis addresses three research questions. The first question is why transactions of over-the-counter derivatives between financial institutions and end-users are vulnerable to "mis-selling". To answer this question, some understanding about the products transacted, participants of the markets and the practice of transactions is required. Hence the thesis begins by taking a look at basic derivative products such as options and forwards and then examines in the nature of some of more complicated products. Then the thesis analyses the nature and characteristics of different groups of participants in the over-the-counter markets. This analysis of the products and the participants shows how some end-users are dependent on the sellers, i.e. financial institutions. Then, an examination of transaction practices explains the conflicts of interest between the financial institution, its sales representatives and end-users. This question and the answer to it will be discussed in Chapter Ⅱ.

The second research question is how current social institutions have dealt with the disputes over "mis-selling" of over-the-counter derivatives. Here, the social institutions mean private law and financial regulation. Aside from these two institutions, private arbitration[12] also provides practical solutions to disputes of "mis-selling" but this private apparatus will

[12] International Swaps and Derivatives Association, 'Memorandum for Members of The International Swaps and Derivatives Association, Inc: The use of arbitration under an ISDA Master Agreement' (2011) 2, <http://www2.isda.org/search?keyword=arbitration> accessed 11th June 2016

not be discussed separately in this thesis because it is usually dependent on the standards and precedents of the two institutions.[13]

Financial regulation, by which is meant the statutory framework defining operational parameters for the financial services sector and statutory regulation empowered by these statutes, sets the mandatory requirements that financial institutions should comply with in transactions of financial instruments including over-the-counter derivatives, and the sanctions applicable to any breach of the requirements. Private law gets involved in disputes of "mis-selling" of over-the-counter derivatives through the courts' rulings on cases brought to them by one of the counterparties. Its role is to correct wrongdoing in the transaction of over-the-counter derivatives by awarding redress for the loss from the derivative contract.[14]

In answering this second research question, the thesis will, firstly examine how financial regulation has dealt with "mis-selling" of over-the-counter derivatives. The thesis will look at the path of evolution by examining the impetus and results of the legislative changes. Doing so will provide an opportunity to understand the goals of financial regulation. And then, the sanctioned cases related with "mis-selling" of over-the-counter derivatives will be reviewed. This review will consider the strategy and approach taken by the regulator, as enforcer of financial regulation, and affords an opportunity to understand how regulation has dealt with "mis-selling" of over-the-counter derivatives in the real world. Chapter III will consider the financial regulation in relation to the second research question.

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[13] Eilis Ferran, 'Dispute resolution mechanisms in the UK financial sector' (2002) *SSRN 298176*; Jonathan R. Hay and Andrei Shleifer, 'Private Enforcement of Public Laws: A Theory of Legal Reform' (1998) 88 The American Economic Review 398, 401

[14] Alastair Hudson, *The Law of Financial Derivatives* (3rd Edition, THOMSON 2002) para 7-01

The thesis, then, will examine private law by analysing the litigation ruled by the courts in relation to "mis-selling" of over-the-counter derivatives. The examination of those cases will help to draw out major legal issues of private law in handling claims of "mis-selling" of over-the-counter derivatives and to deduce the standards of private law. Chapter IV will look into private law in relation to the second research question.

In order to completely answer the second research question, after examining the way that each of the two social institutions regulates "mis-selling" of over-the-counter derivatives, it is necessary to compare the standards of the two institutions. In fact, despite the two institutions dealing with the same issue of "mis-selling" of over-the-counter derivatives, they have diverging standards about what constitutes wrongdoing in transactions. For the same behaviour in transactions of over-the-counter derivatives, private law rules that it is not a misbehaviour to be redressed but financial regulation sees it as a breach of its requirements and sanctions the wrongdoer. The thesis addresses the origin of why the two institutions have sometimes conflicting standards in handling "mis-selling" disputes. Chapter V will discuss this issue of diverging criteria between the two institutions, in relation to answering the second research question.

The third research question is how to achieve harmonized interplay between the two institutions with different standards in regulating "mis-selling" of over-the-counter derivatives. Firstly, it needs examination of whether the two institutions have complementarity in the context of regulating financial instruments transactions, including over-the-counter derivatives. For this, the thesis will analyse the strengths and weaknesses of both institutions to identify complementarity, if any. Then, it will ask what hinders the complementary interplay between the two institutions in the context of the financial services sector. After discussion of the causes hampering the interplay, the thesis suggests proposals to correct these causes. Chapter VI will discuss this third question.

II. THE OVER-THE-COUNTER DERIVATIVES MARKETS

Introduction

The aim of the Chapter is to develop understanding of over-the-counter derivatives and the markets where they are transacted. In doing so, it can answer why "mis-sellng" has been a persistent feature of these markets. Among many different aspects of over-the-counter derivatives, the Chapter will concentrate on those of most relevance to subsequent discussion of the regulation of "mis-selling" of over-the-counter derivatives.

Firstly, the Chapter contains the conceptual analysis on what derivative products are. This analysis includes not only the basic components of derivatives such as options and forwards but also structured products which have gained popularity among investors. Then the market of derivatives will be examined. After taking a brief look at the exchange market, the Chapter will analyse in more depth the over-the-counter market. The analysis will consider the nature of products transacted and participants involved in the markets well as the strategy of financial institutions' marketing of over-the-counter derivatives. Based on the analysis of the products and the market of over-the-counter derivatives, the Chapter will draw out the characteristics of the market and its implications in relation to the following discussions in the thesis.

Secondly, the Chapter will consider over-the-counter derivatives through the lens of law. This part will examine the perspectives of both private law and financial regulation to transactions of over-the-counter derivatives.

2.1 Derivative products

2.1.1 Concept of derivatives

A common definition of derivative is 'a financial instrument, whose values derive from underlying variables.'[15] Underlying variables can be the values of other assets or the occurrence of events. Derivatives in simple forms have been used for thousands of years.[16] In modern times, derivatives started being used explosively from the early 1970s when the Bretton Woods system, which fixed currency rates, was abandoned.[17]

There are two basic categories of derivatives: options and forwards.[18] All derivatives consist of more than one of these two basic components.[19] Options are the right to buy (a call option) or sell (a put option) a certain underlying asset at a certain price (the strike price). Other additional conditions such as a cap, floor or collar can be added to the basic options. A cap places a ceiling on the price of the underlying asset and so protects, for instance, float rate borrowers from interest rate increase. A floor sets a minimum price at which to sell an underlying asset and so protects a seller from a price decline. A collar holds a cap and a floor and so fixes the price movement within a certain band.

A forward is an agreement where a buyer agrees to buy and a seller agrees to sell a certain underlying asset on a specified date at a specified price. Forwards that are traded on the exchange are called "futures". A swap is an agreement to exchange future cash flows and so can be described as a series of forwards. A large variety of derivatives can be created

[15] John C Hull, *Options, futures, and other derivatives* (Pearson Education India 2006) 1

[16] Rasiah Gengatharen, *Derivatives law and regulation* (Vol. 20. Kluwer Law International 2001) 8-12; Roberta Romano, 'Thumbnail Sketch of Derivative Securities and Their Regulation' (1996) 55 Md. L. Rev. 7, 40-41

[17] Willa E Gibson, 'Inverstors, Look before You Leap: The Suitability Doctrine Is Not Suitable for OTC Derivatives Dealers' (1997) 29 Loy. U. Chi. LJ 527, 532; Henry TC Hu, 'Hedging Expectations: Derivative Reality and the Law and Finance of the Corporate Objective' (1994) 73 Tex. L. Rev. 985, 1011

[18] GROUP OF THIRTY, 'GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 29' (1993) 27

[19] Ibid

using the above basic components with different underlying variables such as assets, rates and indices.

The term of 'structured products' describes cash assets such as bonds and deposits, combined with derivatives to provide a pay-off not otherwise available.[20] These products were created to satisfy investors' diverse 'risk-return objectives' decades ago but have become popular as an alternative investment from 2000s.[21] Structured products include structured notes which are debt securities embedded with a derivative[22]: structured capital-at-risk investment products ("SCARPs") whose return is based on a pre-set formula connected to the movement of other variables such as an equity index but where the principal of the investment can be lost; non-SCARPs which have the same pay-off structure as the SCARPs but where its investment principal is protected so long as the issuer of the non-SCARPs is solvent; and the structured deposit which is a deposit whose interest is linked with the performance of other indices or assets.[23] The question of who might use such products and why is addressed in due course.[24]

2.2 Derivative markets

Derivatives can be transacted in two different markets: exchanges and over-the-counter markets. Exchange markets list standardized derivatives such as futures and options, which have pre-set terms and conditions such as maturity and strike price. In over-the-counter

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[20] Robert W Kolb and Overdahl James A, *Financial derivatives: pricing and risk management* (Vol. 5, John Wiley & Sons 2010) 6

[21] Timoth A.Day, 'Structured products' in Tanya S.Beder and Cara M.Marshall, *Financial Engineering: The Evolution of Profession* (1 edition, John Wiley & Sons 2011) 260-261

[22] See Carolyn H Jackson, 'Have You Hedged Today--The Inevitable Advent of Consumer Derivatives' (1998) 67 Fordham L. Rev. 3205, 3224-3225, which described the first advent of structured products.

[23] Financial Conduct Authority, 'Structured Products: Thematic Review of Product Development and Governance' (2015) 25-26

[24] See n61

derivative markets, customized derivatives are bilaterally negotiated and transacted between two counterparties.

2.2.1 Exchange markets

The organised exchange markets for derivatives transactions appeared in the mid-1800s in Chicago;[25] exchange markets were free from credit risks of counterparties because of their clearinghouse function[26]; they were cost-effective in searching counterparties for transactions[27]; they had better price transparency[28]. However, exchange markets have a critical limitation of inflexibility in structures of products and contract terms.[29] While standardization of derivatives can reduce transaction costs, this makes it difficult for hedgers or investors to tailor the derivatives for their specific hedge or investment needs.[30]

For instance, suppose a British company which has receivables of $1.5 million from its foreign importer at the end of February needs to hedge its foreign exchange rate risk. Exchange-traded derivatives such as futures and options may only have a maturity of end of January and $1 million of the amount of a contract unit. With such standardized derivatives, this company cannot fully hedge its foreign exchange rate risk due to the mismatch of maturity and amounts. This is a very simple example of mismatch between the business needs and derivative products available in exchange markets; in the real business world there would be much more complicated cases of mismatch.[31] This

[25] Robert W. Kolb and James A. Overdahl, *Financial Derivatives* (3rd edition, Wiley 2003) 4
[26] Ibid 17
[27] Ibid
[28] Michael Chui, 'Derivatives markets, products and participants: an overview' (2010) China and the Irving Fisher Committee in Zhengzhou on 27–29 September 2010, 9
[29] Robert W. Kolb and James (n 25) 18
[30] Aaron L. Philip, '1995 Derivatives Practices and Instruments Survey' (1995) 24.2 Financial Management 115,123
[31] Federal Reserve Bank of Chicago, 'Understanding Derivatives-Markets and Infrastructures' (2014) 27-28

mismatch problem is a critical issue particularly for those using derivatives to hedge against a particular risk, whose main purpose of using derivatives is to ameliorate the volatility of their business performance. Generally accepted accounting principles such as the International Accounting Standards[32] and U.S. GAAP[33] require hedging products to have sufficient offsetting effect on the value movement of the hedged assets in order for hedge accounting to be applied. This means that a derivative product which does not have a sufficient offsetting effect, for example 80~125% in International Accounting Standards[34], against the hedged asset cannot be recognized as a hedge in their financial statements.

2.2.2 Over-the-counter markets

There is less risk of disputes arising in the transaction of derivatives in the standardized market because it is tightly regulated[35], the structure and features of the products are comparatively simple and transparent and end-users are familiar with the standardized products from repeated uses. Therefore this thesis will focus on the over-the-counter markets.

One of the distinguishing characteristics of over-the-counter markets are their flexibility.[36] In these markets, two counterparties can agree to trade any types of derivatives through an almost limitless range of contractual structures. The flexibility of over-the-counter derivatives is the most prominent strength for hedging against risks in the real business world. Companies can more robustly manage their own specific business risks by using over-the-counter derivatives in a way which is simply not possible with exchange-traded

[32] International Accounting Standards 39
[33] Financial Accounting Standard 133
[34] International Accounting Standards 39
[35] Aaron L. Philip (n 30) 123
[36] Ibid

standardized derivatives.[37] Such flexibility has led to growth in scale of these markets and, as of June 2015, the global notional amount outstanding of over-the-counter derivatives is $553 trillion which is almost 9 times the exchange-traded derivatives markets volume of $63 trillion.[38]

2.2.2.1 Products transacted

Theoretically, anything quantifiable can be used as underlying assets of over-the-counter derivatives,[39] but these markets can be classified into the following major sub-markets: interest rate products with $435 trillion of notional amounts as of June 2015 (same for below), foreign exchange products with $75 trillion, credit default swaps with $15 trillion, equity derivatives with $8 trillion, commodity derivatives with $2 trillion, and others with $20 trillion.[40]

Most[41] of the over-the-counter derivatives are effected through contracts which use the standard documentation created by the International Swaps Derivatives Association ("ISDA") which was organized in 1985 by major financial institutions to facilitate over-the-counter derivatives transactions.[42] These documents include all the necessary provisions for

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[37] COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES, 'The Effective Regulation of the Over-the-Counter Derivatives Market: Hearing Before the Sub comm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H.Comm. on Financial Services', (111th Cong.164, 2009) 18, <https://www.gpo.gov/fdsys/pkg/CHRG-111hhrg52397/pdf/CHRG-111hhrg52397.pdf > accessed 20 July 2016
[38] Bank For International Settlement, 'Semiannual OTC derivatives statistics' table D5, < http://www.bis.org/statistics/derstats.htm> accessed 15 March 2016
[39] Mark A Guinn and Harvey William L, 'Taking OTC Derivative Contracts as Collateral' [2002] The Business Lawyer 1127, 1129
[40] Bank For International Settlement (n 38)
[41] Joanne P Braithwaite, 'OTC derivatives, the courts and regulatory reform' (2012) 7.4 Capital Markets Law Journal 364, n10, which explained that "the ISDA Master Agreement which serves as the contractual foundation for more than 90% of derivatives transactions globally.."
[42] Frank Partnoy, 'ISDA, NASD, CFMA, and SDNY: the four horsemen of derivatives regulation?' (2002) Brookings-Wharton Papers on Financial Services 2002, 213, 217-218

enhancing certainty of transactions, including the obligations and representations of each party.[43]

Over-the-counter derivatives markets are sites of financial and legal innovation and have developed new products such as economic derivatives for entities whose income, for example tax revenue of the government, closely correlates with growth of economy and real estate derivatives for investors who want to hedge their investment in real estate.[44]

2.2.2.2 Participants

The participants in over-the-counter derivatives markets can be classified into two groups, dealers and end-users. Dealers are major financial institutions which sell over-the-counter derivatives to end-users.[45] Dealers become the counterparty of end-users and earn commission which is the gap between the bid and ask prices.[46] The difference of bid and ask prices is decided by how much information the end-user has about prices of other transactions in the market.[47] So opaqueness of price in the market can enhance the profitability of dealers.[48]

Dealers themselves hedge the risk derived from the position of the derivatives transactions with end-users, in order to be insulated from market movements, by using highly sophisticated risk management methodologies.[49] When conducting hedging transactions

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[43] Ibid

[44] Robert W Kolb and Overdahl James A, *Financial derivatives: pricing and risk management* (Vol. 5, John Wiley & Sons 2010) 221-230; Carolyn H Jackson (n 22) 3260

[45] J. Christopher Kojima, 'Product-Based Solutions to Financial Innovation: The Promise and Danger of Applying the Federal Securities Laws to OTC Derivatives' (1995) 33 AM.Bus. L.J. 259, 266

[46] Willa E Gibson, 'Inverstors, Look before You Leap: The Suitability Doctrine Is Not Suitable for OTC Derivatives Dealers' (1997) 29 Loy. U. Chi. LJ 527,539

[47] Darrell Duffie, *Dark Markets: Asset Pricing and Information Transmission in Over-theCounter Markets* (Princeton: Princeton University Press 2012) 5

[48] Ibid

[49] Ibid 540; GROUP OF THIRTY (n 18) 39-40

of over-the-counter derivatives, dealers become end-users.[50] So financial institutions can be dealers and end-users depending on the purpose of transaction.[51] Dealers have substantial sized marketing and risk management functions for transacting over-the-counter derivatives with end-users.

End-users enter into over-the-counter derivatives contracts for hedge or investment purposes, not for commission.[52] Majority of end-users are, based on outstanding volume, financial institutions.[53] Financial institutions are exposed to various financial risks.[54] Most of their assets and liabilities are sensitive to macroeconomic variables such as interest rates, exchange rates and equity markets and so risk management is their core business activity.[55]

Non-financial companies also have many reasons to use over-the-counter derivatives. Firstly, they can reduce volatility of their business performance caused by macroeconomic variables by using over-the-counter derivatives: exporters or importers hedge foreign exchange rate risk; corporations protect the worth of assets and liability from interest rates risk; manufacturers stabilize the cost of raw materials for production. Empirical research has shown that hedging enables corporations to have stable financial performance and enhance the firm value.[56] A survey conducted by International Swaps and Derivatives Association has shown that 94% of the world's 500 largest companies[57] and 62% of UK

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[50] Darrell Duffie (n 47) 8
[51] Ibid
[52] GROUP OF THIRTY (n18) 32-36
[53] Bank For International Settlement (n 38)
[54] GROUP OF THIRTY (n18) 38-39
[55] See John Hull, *Risk Management and Financial Institutions,+ Web Site*, (Vol. 733, John Wiley & Sons 2012)
[56] See eg Söhnke M Bartram, Brown Gregory W, and Fehle Frank R, 'International evidence on financial derivatives usage' (2003) 27, <https://www.researchgate.net/profile/Soehnke_Bartram/publication/23743525_International_Evidence_on_Financial_Derivatives_Usage/links/0fcfd50bad2b7da781000000.pdf>
[57] International Swaps and Derivatives Association, 'Over 94% of the World's Largest Companies Use Derivatives to Help Manage Their Risks, According to ISDA Survey' (2009) 1 <www.isda.org/press/press042309der.pdf> accessed March 2016

non-financial listed companies[58] use derivatives to hedge or manage the risk in their business.

Many SMEs also enter into over-the-counter derivatives contracts. While lack of expertise, resources and scale of economy are the obstacles for SMEs to use over-the-counter derivatives,[59] they have the same reasons for using over-the-counter derivatives as the large corporations. One piece of empirical research revealed that 24% of UK listed non-financial SMEs used derivatives of which over 80% were over-the-counter derivatives.[60]

It is an important trend that individual investors are increasingly investing in structured products embedded with over-the-counter derivatives. Disappointed by low interest rates from ordinary saving products, individual investors seek better returns than are available from interest on savings but, at the same time, they want to protect their investment principal.[61] Structured products which purport to protect against or reduce the risk of losing investment principal and provide higher income than ordinary savings have met this appetite of individual investors. Retail investment in structured products has grown enough to attract the financial regulator's attention.[62]

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[58] Mallin, Chris, Kean Ow-Yong, and Martin Reynolds, 'Derivatives usage in UK non-financial listed companies' (2001) 7.1 The European Journal of Finance 63,68

[59] Joost ME Pennings and Philip Garcia, 'Hedging behavior in small and medium-sized enterprises: The role of unobserved heterogeneity' (2004) 28.5 Journal of Banking & Finance 951,955-957

[60] Giulia Fantini, *Financial Derivatives usage by UK & Italian SMEs. Empirical evidence from UK & Italian non-financial firms* (Diss. Università degli Studi di Ferrara, 2014) 52-53

[61] See eg Financial Services Authority, 'Retail Conduct Risk Outlook' (2011) 47-51 <http://www.fsa.gov.uk/pubs/other/rcro.pdf> accessed March 2016

[62] Financial Services Authority, 'Retail Product Development and Governance-Structured Products Review' (2011); Financial Conduct Authority, 'Structured Products: Thematic Review of Product Development and Governance' (2015); Alex Erskine, 'Retail derivatives: What we know, what we don't know, and regulatory challenges' (2011) 4 JASSA, 55

Expanding the user base of over-the-counter derivatives into SMEs and individual investors has been in large part triggered by 'supply-side' innovation.[63] Risk management techniques have progressed dramatically since the 1990s and this enabled dealers to create derivatives transactions highly tailored to each end-user.[64] This innovation has been accelerated by the race among financial institutions to be 'one step ahead of the competition'.[65]

Within the group of end-users, the level of knowledge and experience in over-the-counter derivatives markets diverges tremendously between financial institutions and other end-users such as non-financial corporations and individuals. Financial institutions, whether as a dealer or an end-user, have sufficient resources to deal expertly with over-the-counter derivatives transactions. Prudential regulation also ensures that regulated financial institutions hold sufficient risk management capability to prevent their failures.[66] Therefore, in over-the-counter derivatives transactions, financial institutions cannot be said consumers but counterparties.[67]

On the contrary, even large non-financial corporations usually do not have designated departments for over-the-counter derivatives transactions, let alone SMEs. They have no

[63] Dan Awrey, 'Toward a supply-side theory of financial innovation' (2012) 23-39 < http://ineteconomics.org/uploads/papers/Awrey-Paper.pdf> accessed November 2015; Henry TC Hu, 'Hedging Expectations: Derivative Reality and the Law and Finance of the Corporate Objective' (1994) 73 Tex. L. Rev. 985, n13

[64] Bruce G Carruthers, 'Diverging derivatives: Law, governance and modern financial markets' (2013), 13 <http://blogs.law.columbia.edu/glawfin/files/2013/10/09-Diverging-Derivatives.-Law-Governance-and-Modern-Financial-Markets-by-Bruce-G.-Carruthers.pdf> accessed November 2015; GROUP OF THIRTY (n18) 39-40

[65] Peter Tufano, 'Financial Innovation and First Mover Advantages' (1989) 25 Journal of Financial Economics 213, 225-234; see also *Morgan Stanley UK Group v Puglisi Cosentino* [1998] C.L.C. 481-482 where the financial institution developed a new type of SCARP, so-called PEARLS, ahead of its rivals and could hold many clients.

[66] John Hull (n 55) 19

[67] FCA Handbook, Conduct of Business Sourcebook ("COBS") 3.6.2R

other choice than to substantially depend, for transactions of over-the-counter derivatives, on dealers to understand the nature and risks of the products.[68] A survey conducted on 800 UK listed companies showed that the difficulty of evaluating the risks and the lack of knowledge of derivatives were their biggest concerns in transacting derivatives.[69] In recognition of this clear difference in expertise, this thesis uses the term "consumers" to include non-financial corporations and individual investors in over-the-counter derivatives transactions hereinafter, a wider sense than with which it is commonly used but, it is argued, the complexity and nature of over-the-counter products justified such wider usage.

2.2.2.3 Marketing

In over-the-counter derivatives markets, financial institutions use 'relationship' marketing,[70] which aims to maximize long term profits by solidifying relationships with clients, rather than focusing on short term or individual transaction profits.[71] Financial institutions designate an account manager who is responsible for developing relationship with consumers and facilitating the sales of a broad range of services and products including over-the-counter derivatives.[72] Because over-the-counter derivatives contracts are usually long-term, complex and large scale, a good "relationship" with consumers is seen as a prerequisite for undertaking transactions.[73] In order to obtain the "trust" from their clients,

[68] Alessio M.Pacces, 'Financial intermediation in the securities markets law and economics of conduct of business regulation' (2000) 20.4 International Review of Law and Economics 479, 482

[69] Chris Mallin, Kean Ow-Yong, and Martin Reynolds, 'Derivatives usage in UK non-financial listed companies' (2001) 7.1 The European Journal of Finance 63,77

[70] Katherine Tyler and Edmund Stanley, 'Marketing OTC equity derivatives: the role of relationships' (2002) 20.2 International Journal of Bank Marketing 67, 72-73

[71] Elizabeth Sheedy, 'Marketing derivatives: a question of trust' (1997) 15.1 International Journal of Bank Marketing 22, 22

[72] Ibid

[73] Ibid 26

account managers should make great efforts to demonstrate that they are interested in a long term relationship.[74]

Financial institutions also try to enhance 'internal marketing' in their organizations.[75] Marketing people recognize their consumers' needs and business opportunities, and "sell" their findings to derivatives engineers in their organizations.[76] This internal marketing process enables financial institutions to develop over-the-counter derivatives products that better meet the needs of each consumer.

2.2.3 Characteristics of over-the-counter derivatives markets

The above sections analysed products and markets of over-the-counter derivatives. Based on this analysis, this section will consider the characteristics of over-the-counter derivatives markets and implications for this thesis.

2.2.3.1 Characteristics

One of the most evident characteristics of over-the-counter derivatives markets is the asymmetry of information and knowledge between sellers and consumers. While the financial services industry is notorious for information asymmetry,[77] the over-the-counter derivatives markets is one of the worst areas even in the industry. First of all, derivatives are unfamiliar products for consumers compared with other commonly transacted financial products like loans, equities and insurance.[78] Consumers have very limited knowledge of and experience in derivatives markets. On the other side, financial institutions have a dominant position in knowledge and experience. They can easily obtain information about

[74] Katherine Tyler (n 70) 71
[75] N. S. Nilakantan, 'Marketing of Derivatives in the Aftermath of Lehman Crisis' (2010) 8.2 Synergy 43, 47
[76] Ibid
[77] David Llewellyn, *The economic rationale for financial regulation* (Financial Services Authority, 1999) 25-26
[78] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding regulation* (Oxford University Press 2011) 18

market conditions including market participants, trends of pricing and the movement of underlying variables. In particular, financial institutions of major dealer banks circulate market information only within their close-knit group of dealers.[79]

The second characteristic is the consumers' heavy reliance on the sales representatives of financial institutions for entering into over-the-counter derivatives contracts. Consumers with insufficient information and knowledge tend to rely on the salespersons' explanation and recommendation of over-the-counter derivatives. It is practically impossible for consumers to compare the price and other terms of non-standardized over-the-counter derivatives among different financial institutions.[80] Asymmetry of knowledge and information forces consumers to rely on financial institutions for obtaining necessary knowledge and information in terms of the over-the-counter derivatives, even the price information. On top of this, financial institutions can exploit the consumer's reliance by "trust" obtained by 'relationship marketing'.[81]

On the supply side, over-the-counter derivatives markets are characterized as being highly profitable and so there is heavy pressure on sales performance. The profits of financial institutions earned through over-the counter derivatives transactions are quite lucrative[82] partly, if not all, due to information asymmetry, consumers' reliance on sellers and opaqueness[83] of price of over-the-counter derivatives. The attractive margins lead to

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[79] Dan Awrey, 'Toward a supply-side theory of financial innovation' (n63) 23

[80] Robert E Litan, *The Derivatives Dealers' Club and Derivatives Market Reform: A Guide for Policy Makers, Citizens and Other Interested Parties* (Initiative on Business and Public Policy at Brookings 2010) 17

[81] Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press, 2010) n191 and n192

[82] Financial Crisis Inquiry Commission, and United States, Financial Crisis Inquiry Commission, *The financial crisis inquiry report: Final report of the national commission on the causes of the financial and economic crisis in the United States* (PublicAffairs 2011) 50

[83] Darrell Duffie, *Dark Markets: Asset Pricing and Information Transmission in Over-the-Counter Markets* (n 47) 7

pressure on salespersons to achieve high sales performance. The pressure is not only business-driven but also self-inflicted due to the compensation system based on personal sales performance[84]. The lucrative profit and generous personal compensation can create blindness[85] to the interest of consumers, if not opportunism[86]. In addition, for salespersons who pursue their private interest, it is rational to exploit their consumers in the short run rather than building up reputation of their employer in the long run.[87]

Lastly, over-the-counter derivatives markets has been expanding its territory in terms of products as well as the users. This expanding trend can continue and so new innovative products can be introduced to the current and new class of consumers.[88]

2.2.3.2 Implication

When the above characteristics of over-the-counter derivatives markets are considered, these markets are deemed to create conditions where "mis-selling" disputes can easily occur. The term "mis-selling" is used often now to mean that consumers have been somehow misled into buying products or services.[89] Consumers, when they enter into over-the-counter derivatives contracts, rely on their account manager or sales representatives of financial institutions to help them achieve their objectives of hedging or investment. Sales representatives have gained trust based on strategic relationship

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[84] See *Zaki & Others v CSUK* [2011] EWHC 2422 (COMM) where a sales person was compensated millions of pounds for selling structured notes to the plaintiff
[85] Christine Cuccia, 'Informational Asymmetry and OTC Transactions: Understanding the Need to Regulate Derivatives' (1997) 22 Del. J. Corp. L. 197, 205
[86] Dan Awrey, 'Toward a supply-side theory of financial innovation' (n63) 23; Andromachi Georgosouli, 'The debate over the economic rationale for investor protection regulation: a critical appraisal' (2007) 15.3 Journal of Financial Regulation and Compliance 236, 239
[87] Alessio M.Pacces, 'Financial intermediation in the securities markets law and economics of conduct of business regulation' (2000) 20.4 International Review of Law and Economics 479, 484
[88] Carolyn H Jackson (n 22) 3207
[89] Oxford dictionary <http://www.oxforddictionaries.com/definition/english/mis-sell?q=mis+selling> accessed March 2016

marketing and provide tailored over-the-counter derivatives to consumers. Self or hierarchical pressure for sales performance can give rise to opportunism or marketing practice blind to the real benefit of consumers.

The market situation of underlying assets can move anytime in an adverse way, contrary to what may be the expectation and understanding of the consumers and even the sales representatives. Sometimes markets even collapse. When suffering loss from adverse and unexpected market movements, consumers who have relied on the sales representatives' explanation and recommendation are likely to think that they were misled to enter into over-the-counter derivatives contracts. This is the typical scenario of how "mis-selling" disputes in the over-the-counter derivatives markets arise. The structure of the market and the nature of participants makes for the perfect environment for such disputes.

2.3 Legal perspectives of derivatives transactions

Previous sections have analysed derivatives products and markets from economic angles. The following sections will take a look at derivatives from legal perspectives and identify legal risks in transacting derivatives.

2.3.1 Legal concepts of derivatives

From the perspective of private law, a derivative transaction is a contract, which creates and allocates personal rights and duties between the contacting parties: setting in advance a method of calculating profit and loss, the amount of money to be paid on a specific date, etc.[90] An enforceable contract does not require high formality in English law; a contract takes legal effect when there are offer, acceptance, consideration and intention

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[90] Timothy E Lynch, 'Derivatives: A Twenty-First Century Understanding' (2011) 43 Loyola University Chicago Law Journal 16 <http://lawecommons.luc.edu/luclj/vol43/iss1/3>; Alastair Hudson, *The Law of Finance* (2nd edition, Sweet & Maxwell 2013) 2-28; Simon James, *The Law of Derivatives* (Routledge, 2014) 20

to create legal relations.[91] A transaction of a derivative is treated by private law as one of many types of contracts.

Among private law, particularly contract law and tort law have obvious relevance to disputes over "mis-selling" of over-the-counter derivatives.[92] Contract law provides the guidance and framework for settling disputes over transactions of financial products about formation, interpretation and termination of contracts.[93] In particular, in many of the disputes of "mis-selling" of over-the-counter derivatives, the performance from the products purchased by consumers are different from what they expected at the time of purchasing and contract law gives the answer as to the validity of the contracts in such cases.[94] In the disputes of "mis-selling" of over-the-counter derivatives, there are also claims of wrongdoings including fraud, breach of contract, negligence in duties and misrepresentation, etc.[95] Tort law may be applied to provide compensation and other remedies when such wrongdoings are found.[96]

In the sphere of public law financial regulation has been involved in "regulating" derivatives transactions since the Financial Services Act 1986 ("FSA 1986") was enacted.[97] FSA 1986 stipulated that no one could carry on 'regulated investment business' in the UK unless he was an 'authorized person' or an 'exempted person'.[98] Schedule 1 to the Act, which defined the scope of the Act, included dealing in derivatives such as options and futures in the 'regulated investment business'.[99] Thereafter, transactions of derivatives where at least one

[91] Simon James, (n 90) 175
[92] Alastair Hudson, *THE LAW OF FINANCE* (n90) para 4.07-4.09
[93] Ibid
[94] Ibid 17-02
[95] Ibid 4-09
[96] Ibid
[97] See n157
[98] Financial Services Act 1986, s3
[99] Financial Services Act 1986, Schedule 1 s7-9

counterparty is an 'authorized person', i.e. a financial institution, have been the subject of financial regulation.[100] Financial regulation has considered transacting derivatives as an activity to be regulated.[101] The involvement of regulation has been further extended as EU legislation such as Markets in Financial Instruments Directive ("MiFID") was implemented as statutory regulation in public law sphere. MiFID will be explained in Chapter III.[102]

The thesis will examine in depth how private law and financial regulation regulate "mis-selling" of over-the-counter derivatives in the Chapter III and IV.

2.3.2 Legal risk of derivatives

Transacting an over-the-counter derivative, which is an apparatus used usually for managing risks, exposes the parties of the transaction to new kinds of risks, including credit risk of the counterparty, market and liquidity risk of the transacted product and legal risk.[103] Among these risks, credit risk, market risk and liquidity risk are all economic risks.[104] Legal risk, in brief, is the risk that derivatives contracts are not enforceable by law.[105] Legal risks can come from several different sources.

The first source of legal risk in transacting over-the-counter derivatives is that a derivative contract can be void because of its nature. For instance, a derivative contract can be unlawful if it is seen as gambling or an unlicensed insurance.[106] *Morgan Grenfell v. Welwyn Hatfield District Council*[107], where the interest rate swap transacted was argued as a

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[100] See n243, explaining selling derivatives is related business under FSMA 2000
[101] Alastair Hudson, *THE LAW OF FINANCE* (n90) para 1.22 - 1.23
[102] Alastair Hudson, *THE LAW OF FINANCE* (n90) para1.24; see n238 and n702
[103] Simon James, *THE LAW OF DERIVATIVES* (Routledge, 2014) 15
[104] Ibid
[105] Ibid
[106] Timothy E Lynch, (n 90) 47-49; Norman Menachem Feder, 'Deconstructing Over-the-Counter Derivatives' [2002] Colum. Bus. L. Rev 677, 728; see also George Walker, Robert Purves, and Michael Blair QC, *Financial Services Law* (OXFORD 2014) Para. 12.04
[107] [1995] 1 All ER1; see also *City Index v Leslie* [1992] 1 QB 98

wagering transaction, is an example case where legitimacy of a derivative contract is questioned. The innovative characteristics of derivative contracts can easily create this risk.[108]

Secondly, legal risk related to the actual counterparty to an over-the-counter derivative transaction can make the contract unenforceable.[109] Some counterparties may not have the legal ability to enter into a derivative contract by the constitution of companies or public entities. Even when the counterparty has legal capacity to enter into a derivative contract, the person purporting on behalf of the counterparty may not have the authority to represent the counterparty in the contract.[110] *Credit Suisse International v Stichting Vestia Groep*[111] is such a case. Here a public entity, a Dutch social housing association, contended that it lacked capacity to enter into certain derivative contracts by its constitution and also that its managing director did not have authority to enter into them. Another example of the legal risk arising from a counterparty is that in a series of litigation about interest rate swaps by the UK local authorities in 1990s, the court ruled that contracting interest rate swaps was beyond the power entitled by the relevant statute to the local governments and so void.[112]

Thirdly, legal risk of an over-the-counter derivative transaction can come from actions during pre-contractual or contractual stage, which may not be compliant with legal or regulatory requirements.[113] The claims of "mis-selling" of over-the-counter derivatives are

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[108] Norman Menachem Feder (n 106) 727
[109] Ibid 728
[110] Simon James (n 103) 16-17
[111] [2014] EWHC 3103
[112] *Hazell v Hammersmith & Fulham* [1992] 2 AC 1; Roger McCormick, *Legal risk in the financial markets* (Oxford University Press on Demand 2010) 205-218; Eddie Cade, *Law Relating to International Banking* (Routledge 1999) para 2.2.
[113] Simon James (n 103) 17-18

the representative example of the legal risk originating from this source. Contract law and tort law in private law provide the principles of permissible behaviours during the negotiating and contracting process.[114] Breach of these principles of private law may give the counterparty a right to rescind the contract or to obtain redress for their consequent loss. Statutory regulation also defines mandatory duties of financial institutions in transacting financial instruments including over-the-counter derivatives.[115] Breach of these regulatory requirements can lead to various sanctions and order of compensation for the loss of the consumer.

Conclusion

This Chapter has provided a more detailed understanding of over-the-counter derivatives markets. It has explained that the combination of options and forwards can make a large variety of derivative products. This flexibility of derivatives enables them to be tailored to meet the specific needs of each consumer.

In terms of the derivatives market, the Chapter illustrated why there should be over-the-counter markets for derivatives. Without over-the-counter markets, users of derivatives cannot fully utilize derivatives and this can result in substantially reduced benefit of using derivatives. Particularly for those hedging, standardized derivatives listed in exchange markets may not provide hedging effect in accounting because they often cannot offset the value movement of hedged assets sufficiently due to their inflexibility.

The Chapter, then, has examined the particular characteristics of the over-the-counter market of derivatives. It explained that participants of this market can be categorized into

[114] See n92
[115] See n101

two groups: dealers who sell proprietary products and end-users who transact these products. It pointed out that financial institutions can be dealers and end-users depending on the purpose of the transaction and that they have sophisticated risk management system and expertise in dealing with over-the-counter derivatives. On the other side, non-financial corporations and individuals are end-users who enter into over-the-counter derivatives for the purpose of hedge or investment and not for earning commission, and they lack in expertise in over-the-counter derivatives.

The Chapter examined the over-the-counter derivatives markets to "mis-selling" disputes. The first "ingredient" of "mis-selling" disputes is that there is asymmetry of information and knowledge between financial institutions and consumers, which results in consumers being dependent on the dealers. The fact that the over-the-counter derivatives are commonly proprietary products which are designed by the seller exacerbates the imbalance of information and knowledge. Secondly, the substantial commission income of the dealer financial institution and generous financial incentives for salespersons contribute to making a good environment for "mis-selling". Lastly, the volatility of the financial market can go against the expectations of the consumer and even the salesperson, resulting in the over-the-counter derivatives to fail to achieve the expected performance.

The Chapter took a look at over-the-counter derivatives transactions from legal perspectives. Private law sees the transactions of over-the-counter derivatives as a process of contracting, while financial regulation takes a view of these transactions as business activities of financial institutions to be regulated. This showed that both private law and public law would try to deal with claims of "mis-selling" of over-the-counter derivatives based on their own perspectives. The following two Chapters now turn to the principles and specific rules of financial regulation and private law in dealing with "mis-selling" of over-the-counter derivatives.

CHAPTER III. REGULATION ON OVER-THE-COUNTER DERIVATIVES TRANSACTIONS

Introduction

There are two social institutions to regulate transactions of over-the-counter derivatives between financial institutions and consumers: regulation and private law. Here, regulation means the statute specifically for financial services and products transactions, and the regulatory rules made by the competent authorities delegated by the statute. The purpose of this Chapter is to understand how the regulation deals with over-the-counter derivatives transactions.

For this purpose it is not enough just to take a look at current regulation. It is necessary to consider why regulation in financial services sector emerged and how it has been evolved up to the current shape. Reviewing the history will provide a wide view for better understanding of the nature and role of regulation, which will be necessary for the later discussion about origins of dissonance between financial regulation and private law in the Chapter V.

Then this Chapter will take a close look at current regulation regime, particularly the regulator and its power to realize its objectives. After this, the Conduct of Business Sourcebook ("COBS") which stipulates specific requirements for investment services including over-the-counter derivatives transactions will be examined in detail. Through the examination, it will be clear what duties the regulation requires in over-the-counter derivatives transactions.

Lastly, the enforcement cases against regulatory contravention regarding "mis-selling" of over-the-counter derivatives will be examined. This will illustrate how the regulatory requirements in the rulebook are embodied "on the ground". Through the analysis of the enforcement cases, it will be possible to comprehend the regulation, enforcement approach and strategy of the regulator more completely.

3.1 Evolvement of regulation

3.1.1 History of regulation

In the twentieth century, there have been three paradigm-shifting legislative changes in financial services sector, from Prevention Fraud (Investment) Act 1939/1958 to Financial Services Act 1986 ("FSA 1986") to Financial Services Market Act 2000 ("FSMA 2000"). As George Walker and others argued the evolvement of regulation was 'event-led process',[116] each of the enactments of those legislations has had impetus for transformation. This section will explore why those paradigm-shifting legislations were pursued and what changes were made.

3.1.1.1 Emergence of financial regulation

It was in the seventeenth century that stock brokers' dealings in bonds and shares first appeared.[117] Even at that time records show that fraud and other false behaviours were prevalent in the market.[118] According to a report by the commissioners appointed by the Parliament, it was said that 'pernicious Art of Stock-Jobbing hath…so wholly perverted the End of Design of Companies'.[119] It described various examples of promotional frauds, asset stripping operations, insider dealing and market manipulation.[120]

[116] George Walker, Robert Purves, and Michael Blair QC, *Financial Services Law* (OXFORD 2014) Para 15.01
[117] Barry Rider, Charles Abrams, and Michael Ashe, *Guide to Financial Services Regulation* (CCH Editions, 1997) para102
[118] Ibid para103
[119] Ibid citing House of Commons Journals, 25 Nov 1696
[120] Ibid

In 1697, the 'Act to restrain the number and ill practice of Brokers and Stock-jobbers' was enacted.[121] This Act stipulated that stock brokers and jobbers could deal in financial instruments only with a license from the Lord Mayor and Court of Aldermen.[122] When obtaining the license, the brokers and jobbers were required to take an oath to do business 'without fraud or collusion, to the best of my skill and knowledge'.[123] In the 1720s, many institutions and individuals suffered losses from the 'South Sea Bubble'[124] and the 'Act to Prevent the Infamous Practice of Stock-Jobbing' was enacted to ban the dealing of all options and short-selling in order to inhibit excessive speculation.[125]

3.1.1.2 Prevention of Fraud (Investment) Act 1939/1958

In the early 1930s, with the boom of trusts, there were many reports of mis-leading advertisements of unit trusts to the public.[126] There were also cases of fraud involving the sales of shares of worthless companies just for margin.[127] However, the general law which mainly used criminal punishments for prominently fraudulent behaviours revealed its limitation to effectively deal with more sophisticated and abusive mal-practices in financial services sector.[128] In response, the government enacted the Prevention of Fraud (Investment) ("PFI") Act 1939, which was later re-enacted as the PFI 1958 Act. The PFI Act is considered the first modern statute to regulate investment services.

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[121] Ibid para105
[122] Ibid
[123] Ibid para106
[124] Havard Business School Baker Library, <http://www.library.hbs.edu/hc/ssb/history.html.> accessed 1 Mar 2015
[125] Barry Rider, Charles Abrams, and Michael Ashe (n117) para106
[126] Modern Law Review, 'Reports of committees: Interdepartmental Committee on Sharepushing (Cmd. 5539)' (1938) 313
[127] Modern Law Review, 'Reports of committees: Fixed and flexible trusts Anderson Committee' (1937) 68
[128] Barry Rider, Charles Abrams, and Michael Ashe (n117) para110

The PFI Act required a person to be licensed by the Department of Trade and Industry ("DTI") in order to deal in securities as a principal or an agent,[129] even though members of a self-regulatory organization (i.e., members of The Stock Exchange or other associations of dealers) were exempt.[130] This system was to try to ensure that only fit and proper persons with a good character and relevant expertise were allowed to deal in securities.[131]

The PFI Act also prohibited making a misleading, deceptive or false statement to induce consumers to invest in securities.[132] This provision was the first explicit statutory provision to prevent fraudulent inducement of investment.[133] Under the PFI Act, the Department of Trade and Industry created a conduct of business rule for licensed persons.[134] This rule required, among others, a licensed person to provide a prospectus containing certain information on the securities offered.[135] The conduct of business rule at the time was basically disclosure-based regulation.

3.1.1.3 Financial Services Act 1986

Background

By the early 1980s, the shortcomings of the PFI Act were becoming increasingly apparent. The regulatory scope of the PFI Act excluded the members of a self-regulatory system, like members of The Stock Exchange and other recognized associations authorized by the DTI.[136] The Act also provided exemption for financial institutions that dealt in transactions

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[129] Prevention of Fraud (Investment) Act 1958, s 1(1)(a),(b) (PFI Act 1958)
[130] PFI Act 1958, s 15
[131] George Walker, Robert Purves, and Michael Blair QC (n 116) Para. 15.09
[132] PFI Act 1958, s 13
[133] George Walker, Robert Purves, and Michael Blair QC (n 116) para. 15.12
[134] PFI Act 1958, s 7
[135] Graham F. PIMLOTT, 'Reform of Investor Protection in the UK--An Examination of the Proposals of the Gower Report and the UK Government's White Paper of January' (1985) 7 Journal of Comparative Business and Capital Market Law 141, 143, citing 1939 Rules, 1939 STAT. R.&O. 2757, Part I, Rule 2
[136] PFI Act 1958, s 15

of securities as their ancillary business.[137] Over time, many financial institutions were able to establish that dealing in securities was ancillary to their main business and get exempted.[138] As a result, the number of exempted firms increased so that the exemption became 'to be regarded as a prized status symbol'.[139]

In addition, the scope of the PFI Act only covered licensed dealers and not investment advisors or investment managers.[140] In terms of coverage of products, it did not cover sophisticated investment products such as futures and options, which were beginning to be developed from 1970s,[141] nor mutual funds where increased investments were being made.[142] Such a narrow scope of financial products and services which the Act covered was another apparent shortcoming.

Thirdly, the regulatory system under the PFI Act was difficult to enforce. Enforcement of statutory regulation relied on criminal punishment which demanded a high standard of proof and so had a low rate of success.[143] Self-regulatory organizations ("SRO") could use only non-legal sanctions, such as adverse publicity and suspension of listing, which were not perceived to be strong enough to make discipline among the market players.[144]

In 1981, scandals occurred that highlighted the need for a comprehensive review of investor protection under the PFI Act. One was where Norton Warburg, an investment management firm, became insolvent with a deficit of £2.5 million. It had invested clients'

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137 PFI Act 1958, s 16(1)(a)(i)
138 Graham F. PIMLOTT (n135) 145
139 L.C.B. Gower, *Review of Investor Protection: A Discussion Document* (HM Stationery Office 1982) 14-15
140 George Walker, Robert Purves, and Michael Blair QC (n 116) para. 15.13
141 See n17; Henry TC Hu, 'Hedging Expectations: Derivative Reality and the Law and Finance of the Corporate Objective' (1994) 73 Tex. L. Rev. 985, 1011; Todd E. Petzel, 'Derivatives: Market and Regulatory Dynamics' (1995) *21* J. Corp. L. 95, 98
142 George Walker, Robert Purves, and Michael Blair QC (n 116) para. 15.12
143 Graham F. PIMLOTT (n135) 148
144 Ibid

money in companies of its own group, which went into default and caused many clients to suffer huge losses.[145] Another scandal shocked the City, where a fund manager of a merchant bank was suspected of having obtained improper benefit from a stock broker.[146] Such scandals raised questions about whether the PFI Act provided proper protection to investors.[147]

Gower report

With a series of scandals and the recognition of shortcomings of the PFI Act, the Secretary of State for Trade asked Professor Gower to review the financial regulatory system for investor protection in the UK in 1981. Professor Gower completed the report[148] ("Gower Report") in 1984 with a discussion document[149] in 1982. In the report, he asserted that financial regulation was not for 'protecting fools from their own folly' but for 'protecting reasonable people from being made fools of'. Under the philosophy, the report contained bold suggestions to reform the financial regulatory system in the UK, most of which were accepted and implemented as the Financial Services Act 1986.

First of all, the Gower Report proposed a regulatory system based on self-regulation subject to governmental supervision.[150] Self-regulation under governmental supervision, he believed, could maintain the strengths of self-regulation such as flexibility and expertise and at the same time complement its shortcomings such as ineffective enforcement and the danger of conflicts of interest between the public and the group members of SROs.[151]

[145] Graham F. PIMLOTT (n135) 146
[146] David Kynaston, *The City of London* (CHATTO & WINDUS LONDON, 2002) 595
[147] Ibid
[148] L.C.B. Gower, *Review of Investor Protection: Report* (HM Stationery Office, Cmd., No. 9215, 1984)
[149] L.C.B. Gower, *Review of Investor Protection: A Discussion Document* (n 139)
[150] L.C.B. Gower (n 148) para 5.11
[151] Ibid 3.09

He also suggested to enlarge the scope which the regulatory system could cover.[152] He recommended that regulation should cover not only securities but also a much wider range of investment products such as financial derivatives. He also stressed the importance of the enforcement of regulation.[153] For this, he recommended that there be civil remedies for consumers suffering loss from regulatory breach.[154]

Changes made by FSA 1986

The FSA 1986 was the first legislation in the UK to formulate a comprehensive regulatory framework for the investment industry.[155] Most of the important concepts for investor protection were developed by this Act. Below are the changes created by the FSA 1986 in relation to investor protection.

The FSA 1986 created a 'practitioner-based, statute-backed' regulatory regime, which consisted of the Securities and Investments Board Ltd. ("SIB") and certain recognized Self-Regulatory Organizations.[156] Compared to the PFI Act, the scope of the new regime had a wider coverage of investment instruments and businesses, including transacting in derivatives.[157]

The legislation enhanced the enforcement power of the SIB.[158] The SIB was given the power to ban individuals guilty of misconduct from being employed by financial institutions[159] and to apply to the court for restitution orders to compensate consumers

[152] Ibid 4.03
[153] Ibid 10.12
[154] Ibid 10.29
[155] George Walker, Robert Purves, and Michael Blair QC, (n116) 15.21
[156] Financial Services Act 1986, s 59 (FSA 1986)
[157] FSA 1986, s 1; FSA 1986, Schedule 1 s7-9
[158] FSA1986, ch 5
[159] FSA1986, s 59

against financial institutions that contravened the rules made by the SIB or SROs.[160] The Act also afforded civil remedies to investors who suffered losses as a result of contraventions of rules by financial institutions.[161]

Regulatory rules

Under the FSA 1986, authorization for carrying on investment businesses could be given by both the SIB and the recognized SROs[162] but the financial institutions authorized by a SRO was not subject to the conduct of business rule made by the SIB but subject to the rule made by the SRO.[163] To avoid the incoherency and complexity between the rules of the SIB and the different SROs, some new provisions were added to the FSA 1986 by the Companies Act 1989.

Firstly, the SIB was granted power to create Principles that applied to all authorized firms.[164] The SIB was also given power to make core rules which were required to be incorporated into SROs' rulebooks.[165] As a result of this amendment, the regulatory rules under the FSA 1986 acquired a three-tier structure: 1) Principles by the SIB, 2) Core Conduct of Business Rules ("Core Rules") made by the SIB and incorporated into the SROs' rulebooks and 3) SROs' rulebooks.[166]

The Principle and the Core Rules promulgated by the SIB included most of the important modern concepts for investor protection. The Principles required financial institutions to

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[160] FSA 1986, s 61; see n690
[161] FSA1986, s 62
[162] FSA 1986, s 7, s 25
[163] FSA 1986, s 48(1)
[164] FSA 1986, s 47A
[165] FSA 1986, s 63A
[166] Iain MacNeil, 'The Future for Financial Regulation: The Financial Services and Markets Bill' (1999) vol 62 The Modern Law Review 725, 731

sustain 'integrity'[167] and 'skill, care and diligence'[168], to obtain 'information about customers'[169], to provide 'information for customers'[170] and to avoid 'conflicts of interest'[171], all the spirit of which still remains in the current 'Principles of Businesses'[172] in the FCA Handbook.

The Core Rules also founded critical obligations of financial institutions, which the COBS, the current statutory conduct rule by FCA, promulgates: 1) 'fair and clear communication'[173], 'informing the risk of the investment'[174], 'prohibition to seek exclusion of obligations'[175], 'suitability'[176] and 'disclosure of charges and remuneration'[177]. The differences between the Core Rules and the COBS regarding the above rules is that in the COBS, most of these rules cover more consumers including 'professional clients' whereas the Core Rules confined most of these rules to 'private customers'. Another interesting difference is that the Core Rules had a specific provision for derivatives transactions, which allowed over-the-counter derivatives transaction with a private client only for the purpose of hedge against his currency risk.[178]

The Securities and Futures Authority ("SFA") was one of the recognized SROs, which was entitled to regulate the investment business including the transactions of derivatives. The SFA, in 1991, also promulgated its own rulebook[179], as one of the third-tier rulebooks

[167] The Securities and Investments Board, The statements of principle (1991) s1
[168] Ibid s2
[169] Ibid s4
[170] Ibid s5
[171] Ibid s6
[172] FCA Handbook, PRIN Principles for Businesses
[173] The Securities and Investments Board, The Core Conduct of Business Rules (1991) s 9
[174] Ibid s 10
[175] Ibid s 15
[176] Ibid s 16
[177] Ibid s 18
[178] Ibid s 27
[179] Securities and Futures Authority rulebook (1991)

under the FSA 1986. The SFA rulebook, in general, did not contain many different concepts for investor protection from the Core Rules, but rather incorporated the provisions of the Core Rules in its rulebook.

3.1.1.4 Financial Services and Markets Act 2000

FSMA 2000 was brought about as regulatory system designed under FSA 1986 becoming ineffective. As boundaries between different financial services sectors blurred in 1990s, the regulatory system under the FSA 1986, which regulated different financial services sectors separately through sector-focused SROs, revealed ineffectiveness.[180] One financial institutions with various businesses in different financial services sectors were regulated by different SROs.[181] This system, thus, created regulatory overlaps and arbitrariness across different financial services sectors.[182] A committee report to the House of Commons showed well the rational of the new legislation:

> The existing arrangements for financial regulation involve a large number of regulators…In recent years there has been a blurring of the distinction between different kinds of financial services… The Government believes the current system is costly, inefficient and confusing… It is not delivering the standard of supervision and investor protection.[183]

With these reasons, the newly elected government in 1997 declared the reform of the financial services regulatory regime as one of its important commitments.[184]

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[180] HM Treasury, *Financial Services and Markets Bill: A Consultation Document part one* (1998) 1

[181] George Walker, Robert Purves, and Michael Blair QC, (n116) 15.30

[182] Deborah A Sabalot, *Butterworths New law Guides: The Financial Services and Markets Act 2000* (LexisNexis 2004) 1.26

[183] Joint Committee of the Lords and Commons on Financial Services and Markets, *First Report* (1999) para 99

[184] Deborah A Sabalot (n182) 1.27

Changes by FSMA 2000

The first priority of the new financial services legislation, Financial Services and Markets Act 2000 ("FSMA 2000"), was to create a single statutory regulator that was responsible for supervising and regulating the entire range of financial services areas including banking, insurance and investment services.[185] As the key impetus of enacting the FSMA 2000 was the creation of a single regulator, the biggest change by the FSMA 2000 was the advent of the Financial Services Authority ("FSA"). The FSA took over the responsibilities and roles of the then existing nine regulators.[186] The most important powers, among others, entitled to the FSA were to make rules and to sanction or intervene in the breach of the rules it made. Under the FSMA 2000, the FSA was able to make and amend statutory rules responding to market developments and to make different levels of rules from principles to detailed rules.[187] The FSMA 2000 also ensured that the FSA could hold sufficient intervention and discipline power to the wrongdoers.[188] The FSA could take actions to prevent problems caused by regulated firms from spreading further and remedy the problems.[189] The FSA would also be able to impose direct sanctions on all authorized firms which failed to comply with the regulatory rules.[190]

Another substantial change created by the FSMA 2000 was the creation of the Financial Ombudsman Scheme ("FOS"). Under the FSA 1986, there were eight different dispute

[185] George Walker, Robert Purves, and Michael Blair QC, (n116) 15.31
[186] Nine regulators were the Securities Investment Board, Personal Investment Authority, Investment Management Regulatory Organization, Securities and Futures Authority, the former Supervision and Surveillance Division of Bank of England, the Building Societies Commission, Insurance Directorate, the Friendly Society Commission, the Registrar of Friendly Societies
[187] See n 236
[188] FSMA 2000, s 66, s 206, s 206A, s 384 and s 55J
[189] Ibid
[190] Ibid

resolution schemes.[191] Under this plural dispute resolution schemes, financial institutions could choose to join a specific dispute scheme and some firms did not have any membership of the schemes.[192] The FOS consolidated then existing eight dispute schemes and bound the regulated firms to it.[193] The FOS can resolve financial disputes 'quickly and with minimum formality'.[194] Under the scheme, a complaint should be determined by what the ombudsman opines 'fair and reasonable in all circumstances'.[195] It means that the ombudsman doesn't need to confine himself to breaches of any principles or rules, but rather, he can consider non-statutory obligations such as the firms' voluntary code.[196] The ombudsman may determine a money award compensating for financial loss of the consumer but the money award cannot exceed the limit of £150,000[197].

Regulatory rules: Conduct of Business Sourcebook

The FSA made the Conduct of Business Sourcebook ("COB") as a part of the FSA handbook of rules and guidance under the FSMA 2000. The COB contained detailed requirements for the financial institutions regarding its business with consumers. The COB replaced the precedent regulator's Core Rules and the separate rulebooks made by different SROs.[198] The FSA's basic approach to make the single conduct rule was to integrate then existing

[191] Banking Ombudsman, Building Society Ombudsman, FSA(SIB) complaints service, Insurance Ombudsman, Investment Ombudsman, Personal Insurance Arbitration Service, PIA Ombudsman, SFA Complaints and Arbitration Services
[192] HM Treasury, *Financial Services and Markets Bill: A Consultation Document part one* (1998) 10.3
[193] Ibid
[194] FSMA 2000, s 225 and Sch 17, Para 2
[195] FSMA 2000, s 226(3) and s 228(2)
[196] Alistair Alcock, *The Financial Services and Markets Act 2000: A Guide to The New Law* (JORDANS 2000) 135
[197] Financial Conduct Authority, *FCA Handbook*, Dispute Resolution: Complaints ("DISP") 3.7.4R
[198] The Investment Management Regulatory Organization ('IMRO'), the Securities and Futures Authority ('SFA'), the Personal Investment Authority ('PIA'). See Financial Services Authority, 'Conduct of Business Sourcebook' (Consultation Paper 45a 2000) 2.11

standards in different rulebooks.[199] In the integrating task of different rulebooks, the FSA put the first priority on 'user-friendliness'.[200] For this, the FSA tried to use terms as simple and easy as possible and make the requirements clear.[201] The second principle was harmonization of regulation across the different investment areas.[202] It did not, thus, create big changes in contents from the SIB's Core Rules.

3.1.1.5 FSA 2010 & FSA 2012

The FSMA 2000 amended by the Financial Services Act 2010 ("FSA 2010") and the Financial Services Act 2012 ("FSA 2012") is the current statute regulating financial markets and services, including over-the-counter derivatives transactions.

The enactment of the two Acts was the statutory response to the "failures" of both the market and regulation to prevent the global financial crisis. The area the FSA 2010 focused mostly on was to maintain financial stability from the costly lessons learned from the crisis. But it also tried to improve overall protection of financial consumers.

The 'consumer redress scheme' was introduced as one of the methods to enhance consumer protection.[203] Under this scheme, the regulator can make regulatory rules requiring relevant financial institutions to establish and operate a consumer redress scheme under which they should provide redress to consumers who suffered loss from their failures of compliance with requirements of statutory duties.[204] This massive power was had

[199] Financial Services Authority, 'Conduct of Business Sourcebook' (Consultation Paper 45a, 2000) 1.6
[200] Ibid 2.13
[201] Ibid
[202] Ibid 2.14
[203] FSMA 2000, s 404
[204] Joanna Gray, 'The Legislative Basic of Systemic Review and Compensation for the Mis-Selling of Retail Financial Services and Products' (2004) 25(3) Statute Law Review 196, 204-206

originally been allowed only the Treasury to authorize the regulator to establish and operate the scheme.

The 'consumer redress scheme' is different from other consumer redress tools[205] in that this scheme is intended to be used for widespread consumer detriments from particular products or practices. Restitution order had been rarely used because this action should be taken on the case-by-case basis and so not useful for the regulator with limited resources.[206] The FOS, another regulatory redress scheme, was also not designed for dealing with large scaled consumer detriments but for dealing with an individual case. The private law, HM Treasury presented, has been incapable of responding generic claims because of complicated processes for a group litigation and inconsistent ruling in different courts, etc.[207]

This scheme was adopted for collective regulatory redress to make up for the failures of regulation and private law in dealing with large scaled consumer detriments. However, the consumer detriments the scheme can address are limited to those that seem that the court would order remedy.[208] Considering the difficulty to prove causality, in the court, between regulatory breach and detriment of consumers, the requisite of judiciary remedy seeming available is an obstacle for the regulator to exploit this scheme.[209] As such, there

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[205] FSMA 2000, s 384
[206] Great Britain H. M. Treasury, *Reforming financial markets* (The Stationery Office, CM 7667, 2009) 113
[207] Ibid 114
[208] Financial Supervisory Authority, 'Guidance note No.10 Consumer Redress Schemes' (2010) para 7.4; see n339
[209] Financial Supervisory Authority, 'Joint Committee on the Draft Financial Services Bill Memorandum from the Financial Services Authority' (2011) 8 <www.**fsa**.gov.uk/pubs/other/pls.pdf>; see Chapter IV 4.5

has been only one usage of this scheme by the regulator until now in relation to a fund named 'Arch Cru' in 2012,[210] and it was not be deployed in dealing with IRHPs scandal.

The FSA 2012 overhauled the regulatory system and created the Financial Conduct Authority ("FCA") which is focused on the conduct of business of financial institutions.[211] The FSA 2012 moved away from a model of unified supervision towards a bifurcated twin peaks structure, with the formation of a conduct of business regulator (the Financial Conduct Authority, "FCA") and the micro-prudential regulator (the Prudential Regulatory Authority, "PRA"). This twin-peak[212] regulatory model is based on the belief that the previous financial regulatory system had failed to cope effectively with the global financial crisis which commenced in 2007.[213] HM Treasury in its White Paper described that the most significant regulatory failing in the turbulence of the crisis was poor and non-responsible supervision for the entire financial system.[214]

However, many stakeholders were also unsatisfied with the predecessor's role as a conduct regulator. The comment by the House of Commons in the appointment report for the first chairman of the FCA well exemplified the dissatisfaction:

> He [the first chairman of FCA] must restore the credibility of the conduct regulator. The FCA is the successor to a body which failed consumers. Although it devoted a great deal of time and effort to

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[210] Financial Supervisory Authority, 'FSA announces redress scheme for Arch cru investors' (2012) <http://www.fsa.gov.uk/library/communication/pr/2012/114.stml> accessed 20 May 2015

[211] Great Britain H. M. Treasury, *A new approach to financial regulation: the blueprint for reform* (The Stationery Office, CM 8083, 2011) 15

[212] See David T Llewellyn, 'Institutional structure of financial regulation and supervision: the basic issues' (6th and 7th June. 2006*)* World Bank seminar Aligning Supervisory Structures with Country Needs, 27-28

[213] Great Britain H. M. Treasury, *A new approach to financial regulation: the blueprint for reform* (n211) 8

[214] Ibid; much research has pointed out that the opaqueness and complexity of over-the-counter derivatives market such as credit-default swaps; See eg Financial Crisis Inquiry Commission, and United States. Financial Crisis Inquiry Commission, *The financial crisis inquiry report: Final report of the national commission on the causes of the financial and economic crisis in the United States* (PublicAffairs, 2011); see also Lynn A Stout, 'Derivatives and the legal origin of the 2008 credit crisis' (2011) Harvard business law review 1

> conduct matters, it left consumers exposed to some of the worst scandals in UK financial history. It created a 'box-ticking' culture whose benefits were far from evident and which still failed to pick up major failures in the making.[215]

The FSA 2012 gave three operational objectives to the FCA: 1) the consumer protection objective, 2) the integrity objective and 3) the competition objective. The consumer protection objective is described as 'securing an appropriate degree of protection for consumers'.[216] The FSA 2012 provides the criteria that the FCA should refer to when deciding 'an appropriate degree of protection'. Firstly, the FCA should be aware of the general principle that 'consumers should take responsibility for their decisions' and at the same time of another general principle that financial institutions should 'provide consumers with a level of care that is appropriate'.[217] This criteria gives the FCA a difficult task to find a balanced position between consumer responsibility and provision of appropriate care to consumers. The FSMA 2000, before being amended by the FSA 2012, did not describe the general principle that financial institutions should provide a level of care for consumers but described only the general principle of consumer's responsibility for his investment decision.[218] This illustrates that the amended Act makes it clear that financial institutions should have clear statutory obligations in a way that they provide proper level of care to consumers when undertaking transactions with them. Secondly, the FCA should understand that there are differing degrees of risk depending on the transaction and that

[215] House of Commons Treasury Committee*, Appointment of John Griffith-Jones as Chair-designate of Financial Conduct Authority* (The Stationery Office, 2013) 3
[216] FSMA 2000, s 1C(1)
[217] FSMA 2000, s 1C(2) (d), (e)
[218] FSMA 2000, s 5(2)

consumers have differing degrees of experience and expertise.[219] This can be the statutory ground of the client categorization in the COBS.[220]

The competition objective is 'promoting effective competition in the interests of consumers'.[221] The competition objective was newly added by the FSA 2012.[222] This was the result of the need for more competition to enhance consumer protection as the market share in the financial services industry concentrated in a few big financial institutions.[223] Healthy competition can enhance consumer protection through lower prices, innovation in products and more choices.[224] With the possibility of conflicts between the consumer protection objective and the competition objective, the FSA 2012 clarifies that the FCA should pursue the competition objective so far as is compatible with the consumer protection objective.[225]

As illustrated above, while the financial stability agenda was key in the regulatory reform process after the global crisis, the consumer protection agenda has also been one of the areas given attention. It can be explained by two-fold why the two Acts for reforming financial regulatory system have included measures for enhancing consumer protection. Firstly, the global financial crisis and the following economic recession illustrated the connectedness of consumer protection with financial stability.[226] Excessive mortgages were loaned to many sub-prime borrowers who could not afford the loans and those mortgages

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[219] FSMA 2000, s 1C(2) (a), (b)
[220] See p49
[221] FSMA 2000, s 1E(1)
[222] FSMA 2000, s 2(2)
[223] Alaistar Hudson, *THE LAW OF FINANCE* (n90) 8-42
[224] Financial Conduct Authority, *The FCA's approach to advancing its objectives* (2013) 38
[225] FSMA 2000, s 1B(4)
[226] Erik F Gerding, 'Subprime Crisis and the Link between Consumer Financial Protection and Systemic Risk' (2009) 5 FIU L. Rev. 93, 95-98

were securitized and spread to the wholesale market.[227] As the defaults of sub-prime mortgagees increased, the securitized products based on the mortgages suffered severe losses which resulted in the crisis of the global financial system.[228] The failures to protect consumers both in retail and wholesale market can be said to have caused the systemic turbulence.[229]

Secondly, the momentum of strengthening policy for consumer protection was triggered by the crisis in public confidence in the financial industry. The global financial crisis made consumers lose trust and confidence in financial institutions. Dried-up liquidity and squeezed profitability of financial institutions drove them to turn their backs to consumers' needs, which directly impacted the confidence level. Financial institutions, under the pressure of liquidity during the crisis, tightly reduced its lending to individuals and SMEs when the consumers really needed funding.[230] Tumbling profitability of financial institutions also affected the increase of complaints from consumers.[231] In particular, publicly-funded bailout for failed financial institutions raged the public and raised antipathy to the financial industry.[232] The public anger pushed people to voluntarily organize movements such as 'Occupy Wall Street'[233] and 'Occupy London'[234]. The organized angry

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227 Ibid
228 Ibid
229 Ibid
230 Great Britain H. M. Treasury, *Reforming financial markets* (n 206) 44
231 Ibid 111
232 Niamh Moloney, 'The Legacy Effects of the Financial Crisis upon Regulatory Design in the EU' in Eilís Ferran et al, *The regulatory aftermath of the global financial crisis* (Kindle Edition, Cambridge University Press, 2012) Location 5055-5080
233 See Colin Moynihan, 'Officials Cast Wide Net in Monitoring Occupy Protests', *The New York Times* (22 May 2014) <http://www.nytimes.com/2014/05/23/us/officials-cast-wide-net-in-monitoring-occupy-protests.html> accessed February 2015
234 Caroline Davies, 'Occupy London protest continues into second day', *The Guardian(16 October 2011)* <http://www.theguardian.com/uk/2011/oct/16/occupy-london-protest-second-day>accessed April 2015

voice of the public put political pressure on policy makers to move for enhancing consumer protection.[235]

3.1.2 Conduct of business rules in over-the-counter derivatives transactions

The previous section has examined how statutory regulation in financial services sector has been evolved until now. This section will take a close look at the current regulatory rules stipulating specific requirements in transactions of over-the-counter derivatives.

Rule-making is one of the FCA's overarching power to maintain discipline in financial services sector. The regulator may make rules applying to financial institutions with respect to the carrying on of 'regulated activities' and take disciplinary actions against breach of the rules.[236] Regulatory rules and disciplinary actions are pivotal instruments for the FCA to implement its objectives.[237]

The COBS of the FCA Handbook is the current statutory rulebook, stipulating detailed requirements of financial institutions in carrying on business with their consumers. While the FSMA 2000 sets the overall framework for the financial regulatory system, the COBS is concerned with proper ways of how financial institutions deal with consumers and stipulates all detailed requirements on financial institutions. It is, thus, a critical part in understanding regulation to figure out how the COBS "regulates" over-the-counter derivatives transactions.

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[235] Niamh Moloney, 'The Legacy Effects of the Financial Crisis upon Regulatory Design in the EU' (n 232) Location 5055-5080

[236] FSMA 2000, s 137A(1)

[237] HL Committee Stage, 27 March 2000, col 527, at <http://hansard.millbanksystems.com/lords/2000/mar/27/financial-services-and-markets-bill-1> accessed April 2015

3.1.2.1 Background

The COBS took effect as of November 1, 2007, replacing the previous conduct of business sourcebook implemented in 2000. The FSA, the competent regulator at that time, announced two purposes of implementing the COBS in 2007. The first purpose was to adopt Markets in Financial Instruments Directive ("MiFID") of the European Union by the 'intelligent copy' approach, which meant to "copy-out" texts of the MiFID to avoid unnecessary mis-interpretation.[238] The second purpose was to move towards principle-based regulation.[239] The COB contained many detailed rules which had proved ineffective in correcting market failures, and it was blamed for the regulated firms having in the 'tick-box' approach to each rule without considering the purpose of the regulation.[240]

The COBS defined the areas it would be applied to as 'designated investment business'[241] and 'MiFID business'[242]. Dealing in transactions of over-the-counter derivatives is a 'designated investment business' and a 'MiFID business' and so regulated by the COBS.[243]

Breach of rules of the COBS does not in itself constitute offence[244] nor make any transaction void or unenforceable.[245] But it can trigger the regulator's disciplinary actions.

[238] Great Britain H. M. Treasury, *Reforming financial markets* (n 206) 2.11
[239] Ibid
[240] Alastair Hudson, *THE LAW OF FINANCE* (n90) 9-06
[241] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001
[242] See FCA Handbook glossary where MiFID business is 'investment services and activities and, where relevant, ancillary services carried on by a MiFID investment firm'.
[243] See FCA Handbook glossary where derivatives are a 'designated investment' and selling derivatives is a 'designated investment business'. Derivatives are a 'financial instrument' and 'dealing financial instruments on own account' or 'underwriting or placing financial instruments' are 'MiFID business'.
[244] FSMA 2000, s 138E(1)
[245] FSMA 2000, s 138E(2)

Other than the regulator's sanction, the contravention of the rules is actionable at a suit by 'a private person'[246] who suffers loss as a result of the contravention.[247]

3.1.2.2 General obligation

(1) Client's best interest

The process of distributing investment products is exposed to conflict of interest between the seller and the consumer.[248] The commission-based incentives of financial institutions and insufficient capability of consumers of evaluating the features of the product and the incentive structures give rise to the conflict of interest.[249] Consumers including corporate clients tend to rely on financial institutions when transacting financial products, and there is informational asymmetry between them.[250]

Imposing fiduciary duty, according to economic analysis of law, can be an efficient way of solving the problem of asymmetric information between contracting parties.[251] The principal can minimize his cost to protect his interest by hiring a fiduciary with better information and by imposing duty of utmost faith on him.[252] The COBS has adopted the fiduciary duty as the basic requirements on financial institutions in transacting financial products to protect interest of consumers.[253] It has introduced a general clause requiring that 'a firm must act honestly, fairly and professionally in accordance with the best of interests of its client'.[254] This provision is called 'the client's best interest rule'.[255] This rule

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[246] Financial Services and Markets Act 2000 (Right of Action) Regulations 2001, 2001 No.2256, s3
[247] FSMA 2000, s 138D(2)
[248] Niamh Moloney, *EU Securities and Financial Markets Regulation* (Oxford University Press 2014) 771
[249] Ibid
[250] See p18
[251] Richard A. Posner, *Economic Analysis of Law* (6th edition, Aspen Law and Business 1998) 114
[252] Ibid
[253] European Capital Markets Institute and Centre for European Policy Studies, 'MiFID 2.0: Casting New Light on Europe's Capital Markets' (2011) 126-129
[254] FCA Handbook, COBS, 2.1.1(1)R
[255] Ibid

requires the financial institution to seek proactively its client's best interest ahead of its own interest and this requirement is more than to avoid conflict of interest.

In addition, the COBS prohibits, as one of general obligations, the financial institution from excluding any obligation set by the regulatory system,[256] explaining that seeking to avoid the regulatory duties does not comply with the 'client's best interest rule'.[257] This means that statutory regulation would be 'mandatory' rules to financial institutions, which cannot be modified by contracts at least in the "public sphere", whereas in "private sphere" contract law is not mandatory but default rules.[258]

(2) Client categorization

The COBS has a structure to provide multi-layered level of protection to different groups of consumers with divergent levels of knowledge and expertise. Consumers are heterogeneous ranging from an individual without experience of investment to sophisticated institutional investor. Providing the same level of protection to the heterogeneous consumers puts burdens to the consumers with ability of self-protection, which can reduce the dynamic of the financial market. Client categorization illustrates the characteristics of the COBS as 'asymmetric paternalism', in that it tried to 'create large benefits for those people who are bounded rational while imposing little or no harm on those who are fully rational.'[259]

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[256] FCA Handbook, COBS, 2.1.2R
[257] FCA Handbook, COBS, 2.1.3G
[258] Péter Cserne, *Freedom of Contract and Paternalism: Prospects and Limits of an Economic Approach* (Palgrave Macmillan 2012) 57-58; Hugh Collins, 'The hybrid quality of European private law' in Tatjana, Josipović, et al, *Foundations of European Private Law* (Hart Publishing 2011) 457
[259] Colin Camerer et al, 'Regulation for Conservatives: Behavioral Economics and the Case for Asymmetric Paternalism' (2003) 151.3 University of Pennsylvania law review 1211, 1219

The COBS categorizes consumers into three groups: eligible counterparties, professional clients and retail clients. An eligible counterparty is the most sophisticated and so is the least protected by the COBS.[260] Eligible counterparties include financial institutions such as credit institutions, investment firms, insurance companies, collective investment firms and national governments.[261] It should be noted that the eligible counterparty category is available only for 'eligible counterparty business' which are 'dealing on own account', 'execution of orders on behalf of clients', etc.[262] Thus, a credit institution, for example, cannot be categorized into 'eligible counterparty' if the financial service it is provided with is outside of the 'eligible counterparty business'.

The next sophisticated group is 'professional clients'. Financial institutions with transactions outside 'eligible counterparty business', other institutional investors, local authority are included in 'professional clients'.[263] In addition, large undertakings satisfying certain criteria on the size are also classified into 'professional clients'.[264] Retail clients are consumers who are not 'eligible counterparties' nor 'professional clients'.[265] Majority of individual persons and SMEs are 'retail clients' and they are the most protected consumer group under the COBS.

3.1.2.3 Rules about transactions of over-the-counter derivatives

Among many requirements in the COBS, the most relevant rules related with transactions of financial products including over-the-counter derivatives are what products should be recommended and how the communication for the recommendation should be done.

[260] FCA Handbook, COBS, ch3
[261] FCA Handbook, COBS, 3.6.2R
[262] FCA Handbook, COBS, 3.6.1(2)R; FCA Handbook, Glossary, "eligible counterparty business"
[263] FCA Handbook, COBS, 3.5.2(1)R
[264] FCA Handbook, COBS, 3.5.2(2),(3)R
[265] FCA Handbook, COBS, 3.4.1R

Following parts will examine the requirements on what and how transactions should be carried on.

(1) What to recommend

Behavioural studies have proven that disclosure of material facts is not enough to protect consumers because of their bounded rationality in processing information.[266] Regulation, hence, has moved from 'duty to disclose' to more paternalistic duty of recommending suitable products to consumers.[267] Suitability rule can be said one representative duty of paternalism in financial regulation for protecting consumers from their self-harming behaviour of choosing wrong products.

The COBS demands financial institutions to recommend a suitable product to their consumers when they provide a personal recommendation.[268] This rule has high relevance with over-the-counter derivatives transactions in that it is common that a financial institution provides a personal recommendation when an over-the-counter derivative is transacted, because the financial institution usually designs the product by itself and the consumer tend to lack knowledge of the recommended financial derivative.[269] Retail clients and professional clients are covered by this suitability rule but the financial institution can assume that professional clients have sufficient knowledge and experience to understand the risk of the recommended product.[270]

In order to help apply the somewhat abstract concept of suitability, the COBS divides suitability into three sub-parts: investment 'objectives', 'financial capability' and 'knowledge

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[266] Christine Jolls, Cass R. Sunstein, and Richard Thaler, 'A behavioral approach to law and economics' [1998] Stanford law review 1471, 1533-1537

[267] European Capital Markets Institute and Centre for European Policy Studies (n 253) 127-128

[268] FCA Handbook, COBS, 9.2.1(1)R

[269] See p53

[270] FCA Handbook, COBS, 9.2.8(1),(2)R

and experience'.[271] The first step to ensure suitability is to obtain the necessary information from the consumer: 1) what the client's investment objectives are, 2) what his financial capability (or financial situation) is and 3) what his knowledge and experience is in the specific investment field.[272] Information on investment objectives should include the client's risk profile and the purposes of the investment.[273] Information about the client's financial capability should include information on his regular source of income, his assets, investments and his financial commitments.[274] After understanding the consumer, the financial institution should recommend a personal investment product which meets the three sub-parts of suitability.[275]

The financial institution can be reliant on the information provided by the client when assessing suitability unless the information is manifestly out of date or inaccurate.[276] When it cannot obtain the necessary information for assessing suitability, it must not make a personal recommendation.[277] If the client keeps asking to proceed with a transaction despite the financial institution refusing to make a personal recommendation due to insufficient information about the client, it can arrange the transaction with the client's written confirmation of the instructions.[278] The suitability rule, thus, can be said 'libertarian paternalism' which respects autonomy of people with bounded rationality but tries to help them to avoid self-harming decisions.[279] This is in line with the regulator's consumer

[271] FCA Handbook, COBS, 9.2.1R
[272] FCA Handbook, COBS, 9.2.1(2)R
[273] FCA Handbook, COBS, 9.2.2(2)R
[274] FCA Handbook, COBS, 9.2.1(3)R
[275] FCA Handbook, COBS, 9.2.2(1)R
[276] FCA Handbook, COBS, 9.2.5R
[277] FCA Handbook, COBS, 9.2.6R
[278] FCA Handbook, COBS, 9.2.7G
[279] Sunstein, Cass R, and Thaler Richard H, 'Libertarian paternalism is not an oxymoron' [2003] The University of Chicago Law Review 1159, 1163

protection objective which requires balance between consumers' responsibility for their investment decisions and providing of appropriate level of care for consumers.[280]

(2) How to communicate

Communication between financial institutions and consumers in the pre-contractual stage is the main source from which consumers obtain information about the financial product which will be transacted. Particularly in transactions of over-the-counter derivatives which are usually proprietary products, consumers cannot help but rely on the explanation about the product features and risks given by representatives of financial institutions, the manufacturer of the product.[281] In fact, among civil cases of "mis-selling" of over-the-counter derivatives, many are related with claims of consumers being misled by communication with financial institutions.[282]

The COBS sets out rules about how financial institutions should communicate with consumers while carrying on its investment business. These rules of the COBS covers the contents as well as the method of communication. Among these rules, 'the fair, clear and not misleading rule' provides the base of the communication rules of the COBS.[283] This requires that 'a firm must ensure that a communication is fair, clear and not misleading'.[284] This rule applies to all three categories of clients, but in a proportionate way which means that the method and contents of the communication can differ by different client groups.[285]

This rule requires a financial institution to provide not only factually right information but also "fair" information. Fair communication means it should contain suitable information

[280] See n217
[281] See p19
[282] See Table2 at 107
[283] FCA Handbook, COBS, 4.2.1(1)R
[284] Ibid
[285] FCA Handbook, COBS, 4.2.2(1)G

for the client and should provide a balanced view of the investment at issue.[286] Fairness can be said to require fiduciary obligation because the firm should reason what information is suitable and balanced from the best interest of the client.[287] Under this rule financial institutions should make clear the risk that the product has on the client's capital.[288] Negligence of explaining a product's risk on capital cannot be interpreted as fair and clear communication. Using words in their promotion such as 'guaranteed', 'protected' or 'secure' can be deemed as breach of this regulatory duty.[289]

Financial institutions also should provide sufficient information about charge or fee when the charging structure is complex.[290] This guidance is especially important in the transactions of over-the-counter derivatives, because the commission of over-the-counter derivatives is usually included in the bid and ask price and so most consumers cannot easily estimate the amount of commission out of the bid and ask price.[291]

3.2 Enforcement of regulation

The previous section examined the evolvement of regulation and took a close look at the current regulatory rules particularly related with business conduct of over-the-counter derivatives transactions. This section will examine how those regulatory rules have been enforced by the regulator.

Regulation is not complete with just rules in the book but become complete with enforcement.[292] Different approaches of enforcement will create different outcomes even

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[286] Alastair Hudson (n223) 10-19
[287] Ibid
[288] FCA Handbook, COBS, 4.2.4(1)G
[289] FCA Handbook, COBS, 4.2.5G
[290] FCA Handbook, COBS, 4.2.2(3)G
[291] See n46; Bank of England, *THE LONDON CODE OF CONDUCT* (1995) para 121
[292] G-20 Working Group, 'Enhancing Sound Regulation and Strengthening Transparency: final Report' (2009) 44; R Baldwin and M Cave, Understanding Regulation: Theory, Strategy and Practice (Oxford, 1999) Ch 8

with the same rules.[293] One of the reasons of such variance is the interpretation of the written rules. Rules cannot prescribe in advance all the situations of the future and so depend on the enforcer's interpretation of rules.[294] Another reason is the different strategies of how to utilize the limited regulatory resources for enforcing.[295] Therefore, in order to understand regulation, it is critical to examine how the rules are interpreted and what enforcement strategy is adopted.

This section will first take a look at individual sanctioned cases related with "mis-selling" of over-the-counter derivatives. This will illustrate how the regulator interprets the rules in the rulebook and what the regulator actually requires financial institutions to do in the market place. The next part in the section will examine the regulator's consumer redress cases and understand the regulator's compensation policy.

3.2.1 Regulator's disciplinary actions

One of the tools for enforcement of regulation is disciplinary actions against financial institutions which contravened regulatory requirements. Since 2000, when the single regulator was created, there have been 8 cases where the regulator took disciplinary actions against "mis-selling" of over-the-counter derivatives. The rules breached were, in most cases, the 'fair, clear and not misleading communication'[296] rule and suitability[297] rule.

Before getting into the detailed disciplinary cases, taking a look at FSA's Treating Customers Fairly ("TCF") initiative will be helpful to understand the regulator's stance

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[293] Robert A Kagan, 'Editor's introduction: Understanding regulatory enforcement' (1989) 11.2 Law & Policy 89, 92

[294] Katharina Pistor and Chenggang Xu, 'Incomplete law' (2002) 35 NYUJ Int'l L. & Pol. 931,946

[295] Iain Macneil, 'Enforcement and sanction' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (OUP Oxford 2015) 268

[296] FCA Handbook, COBS s4

[297] Ibid s9

towards enforcement actions. TCF initiative was launched in 2004 and since then it has been the centre of its consumer protection policy.[298] It was not a production of new rules but a clear expression of required outcomes from the existing rules. The FSA suggested six outcomes from TCF: 1) consumer's confidence of financial institutions' culture of treating consumers fairly; 2) products and services which meet the needs of consumers; 3) provision of clear information to consumers before and after sale; 4) suitable advice to consumers; 5) products which perform as expectation; 6) No post-sale barriers to change purchase decisions.[299] These six outcomes of TCF is reflected on the regulator's goal in supervision and enforcement actions.[300]

3.2.1.1 Fair, clear and not misleading communication rule

(1) Unbalanced Prospect

All investments in financial instruments including the over-the-counter derivatives involve uncertainty about the future. Because of this, in the sales process, the financial institution is expected to deliver to consumers its own opinions about future market movement. However, highlighting only the bright side of the prospective investment without appropriate warnings about the risk is a breach of the 'fair, clear and not misleading' communication rule.[301]

In 2003, Chase de Vere Financial Solutions promoted a derivative product connected with the performance of the FTSE 100.[302] The investor of this product was offered double the growth of the FTSE 100 and a loss when the index fell. The firm advertised this product

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[298] Financial Services Authority, 'Treating customers fairly-progress and next steps' (FSA, 2004)

[299] Financial Services Authority, 'Treating customers fairly-towards fair outcomes for consumers' (FSA, 2006) para 1.2

[300] Financial Services Authority (n298) para 2.6

[301] Ibid 4.2.1

[302] Financial Services Authority, 'Final Notice to Chase de Vere Financial Solutions plc' (2003)

throughout the national newspapers as 'fantastic' and 'excellent' with the warnings about the risk in fine print on another page; emphasized a rosy forecast about the equity market without a balanced warning of the risk of the downturn of the market.[303] This advertisement was sanctioned by the FSA as a breach of 'fair, clear and not misleading' communication rule.[304] It is noteworthy that risk warnings in fine print on another page could not protect the financial institution from being sanctioned by the regulator. In fact, many researches in behavioural economics show that majority of consumers don't read fine printed disclosures in their purchases[305] and even reading the disclosures cannot change their decision due to heuristic biases[306].

Santander also had a penalty imposed due to its statements of opinion stating only the up-side market direction. From 2010 to 2012, it sold investment products through its sales representative's advice, which included a structured investment with capital protection and additional returns linked to the FTSE 100. The advisers of the firm presented to consumers their personal forecast that 'the investment will likely double' and stated 'in ten years it will beat cash by 87%'.[307] In addition, the FSA found the firm using its investment forecast tool in a misleading way: in order to make the investment look more attractive, the firm used the Bank of England's base rate which was not thought to be an actual money market return for comparison with the expected return of the investment.[308]

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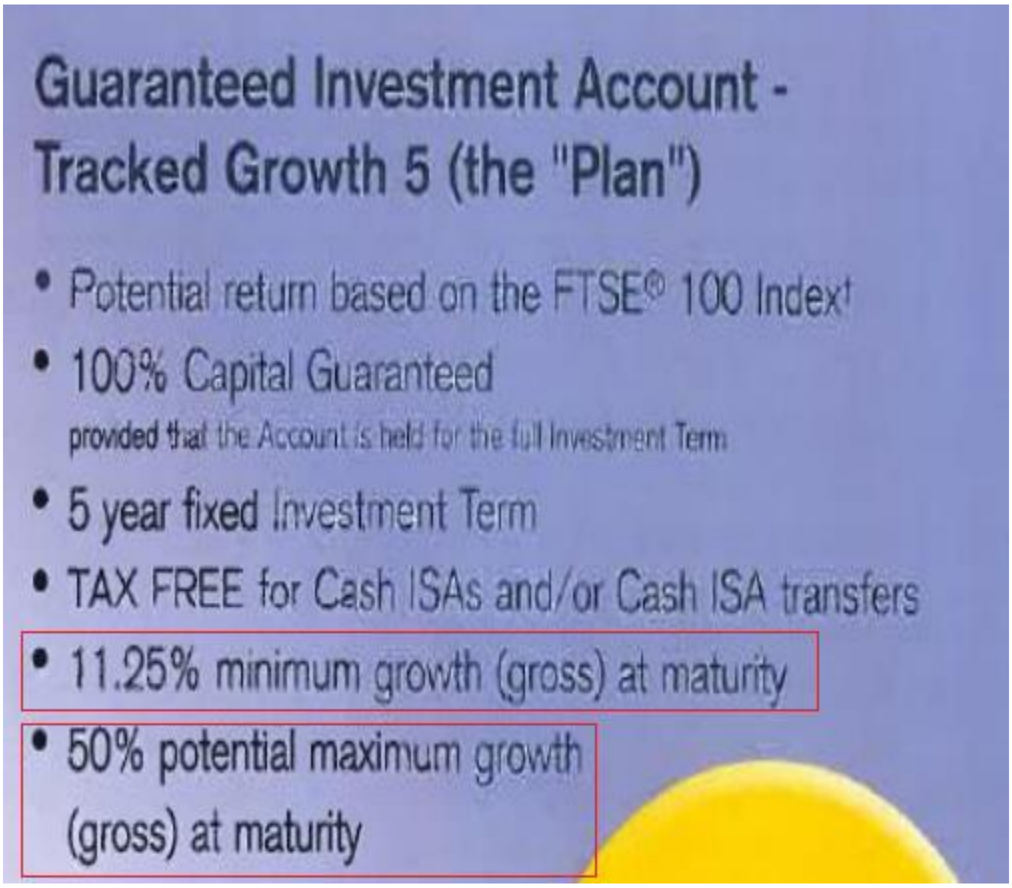
303 Ibid
304 Ibid
305 Bakos, Yannis, Florencia Marotta-Wurgler, and Trossen David R., 'Does anyone read the fine print? Consumer attention to standard form contracts' (2014) 43.1 *Journal of Legal Studies* 33-34 <http://lsr.nellco.org/cgi/viewcontent.cgi?article=1199> accessed 16 February 2016
306 Stephen M Bainbridge, 'Mandatory disclosure: A behavioral analysis' (2000) 68 University of Cincinnati Law Review 18-36 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=329880> accessed 2 January 2016
307 Financial Conduct Authority, 'Final Notice to Santander UK plc' (24 March 2014)
308 Ibid 4.38-42

Promoting a feature of an investment product which has a very slim chance to be realized was also decided as an unfair and misleading communication, although it was not a completely false statement. In 2014 Credit Suisse International ("CSI") developed a derivative product which guaranteed a minimum return but with a cap of maximum earnings. This product was embedded with an option based on the FTSE 100 and so it could generate additional profit if the index performed well. The product that the firm distributed through its branches and other suppliers displayed the guaranteed minimum return and potential maximum return with an equal prominence (see below).



[309]

But CSI's internal analysis showed that the probability that the maximum return would be realized was near zero such that the maximum return would not happen in the simulation based on historical data since the FTSE 100 was launched in 1984. The FSA judged that

[309] Financial Conduct Authority, 'FINAL NOTICE to Credit Suisse International' (2014)

highlighting the potential maximum return which was not realistically expected to be achieved, even though the probability was not exactly 0%, was misleading and not fair, and imposed a financial penalty on CSI.[310]

(2) Unfair and misleading disclosure

False statements about the features or conditions of a derivative product are representative examples of unfair and misleading disclosures. This malpractice is usually related to the concealment of costs, product structures and other risky features of an investment. Chase de Vere had penalties imposed on it because of its advertisement material asserting that there was no charge for a consumer to pay where that was not the case. Charges were designed to be deducted from the return of the investment at maturity and this fact was in fine print on another page.[311] Santander was also sanctioned on the false statement that no commissions were charged for a structured investment product when in fact there was a 7.75% charge.[312] In the sales process of interest rate hedging products ("IRHPs"), banks sold the products to consumers by stating falsely that the IRHP was a pre-condition of providing a loan, and ultimately the banks were required to compensate for the consumers' detriment.[313]

No disclosure or insufficiently detailed disclosure of important aspects of a financial derivative product was also seen as unfair and misleading communication. Banks agreed with the regulator to compensate the loss from a non-cap IRHP, where the detailed information about the cost of non-cap products such as swaps or collars was not delivered

[310] Ibid
[311] Financial Services Authority, 'Final Notice to Chase de Vere Financial Solutions plc' (2003)
[312] Financial Conduct Authority, 'Final Notice to Santander UK plc' (2014) 4.25-28
[313] Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' (A letter to relevant banks) (2012) annex2. 16

to consumers when they did not want to buy the cap due to its up-front premium[314] or where break cost which would occur with early termination of the IRHP was not explained fully and clearly.[315] Explanation on only the existence of the break cost could not give protection to the firms. Credit Suisse International was disciplined for not providing detailed information about an early exit fee which was posed on the termination of the investment before maturity even though the existence of the fee was explained.[316]

3.2.1.2 Suitability rule

(1) Unsuitable advice

Recommendation of investments incompatible with the consumer's circumstances was sanctioned as unsuitable advice. In 2012, the FSA announced, as a result of its mystery shop, that Santander failed to gather sufficient and necessary information about its clients before recommending investment products. The firm's online tools and training programmes for the advisers were not deemed adequate for the firm to obtain sufficient and necessary information about the consumers' knowledge and experience, investment objectives, risk profiles, and the ability to bear the risk of investment.[317] As a result, 42% of recommendations in mystery shops by the FSA were found to be unsuitable or unclear in suitability including examples such as where an adviser recommended a high risk investment without considering the consumer's payment of credit card debt or where an adviser recommended a 71 year old consumer to invest in a 6 year maturity product with a high early exit fee.[318]

[314] Ibid annex2. 25
[315] Ibid annex2. 22(ii)
[316] Financial Conduct Authority, 'FINAL NOTICE to Credit Suisse International' (2014) paras 5.1-5.9
[317] Financial Conduct Authority, 'Final Notice to Santander UK plc' (2014) paras 4.31-37
[318] Ibid 4.59~61

The regulator also viewed overly concentrated investment in a risky asset as an evidence of unsuitable advice. Lloyds TSB Bank ("LSTB") sold from 2000 an investment product of which return was dependent on the performance of 30 shares selected from the FTSE 100. This product sought a high annual return of around 10% but would put the principal of the investment at risk when the price of selected shares fell below a certain level. The FSA found that the firm did not consider the concentration risk in consumers' portfolio: 84% of the consumers with no experience of stock investment had invested over 20% of their total financial assets in the product; 18% of the consumers with experience of stock investment had invested over 35% of their total financial assets in the product. The FSA also recognized that the firm did not provide any guidance on concentration risk to its sales persons. The FSA sanctioned the firm as breach of suitability rule.[319]

Over-hedging IRHPs with a longer term or larger value than those of the hedged loans were also seen as an unsuitable advice and non-compliant sales.[320] The regulator requested the bank to demonstrate that the consumer understood the risk of over-hedging in order to prove the legitimacy of the over-hedging.[321]

(2) Failure to gather information about consumers

The failure to collect information about consumers before providing advices is a breach of regulation, whether or not the advice provided is suitable. JP Morgan International Bank ("JPMIB") provided advice on investments to high-wealth individuals and some of its advice from 2010 to 2012 was reviewed by the FCA. The review revealed that in many advices given the firm did not collect the necessary information about consumers, including

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319 Financial Services Authority, 'FINAL NOTICE to Lloyds TSB Bank plc' (2003)

320 Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' (A letter to relevant banks) (2012) annex2.30

321 Ibid annex2.31

financial circumstances, knowledge and experience about the investment, risk profile and ability to bear the investment risk, and so could not decide the suitability of the recommendation because of the lack of information of the consumers. This led to the review of the whole range of 1,416 instances of advices during this period, but only one case was detected as unsuitable because its advisers could prove the suitability of their advices through their personal memory and evidence. Even though almost all investment advices were proved to be suitable, the FCA decided on a sanction[322] on JPMIB for breaching the Principle[323] that a firm should organize and control its affairs with an adequate system of risk management and the rule of Senior Management Arrangement, Systems and Controls Sourcebook which requires the firm to record its business and all transactions to enable the regulator to review the firm's compliance of the regulatory requirements.[324]

Credit Suisse UK Limited ("CSUK") was also sanctioned on the failure to gather necessary consumer information. CSUK sold structured capital at risk products ("SCARPs") of which return was tied with FTSE 100 or other individual equities. The FSA investigated CSUK's sales practice of SCARPs during the period from 2007 to 2009 and found the following failings[325]: unclear risk indicators in the internal form for gathering client information; increase of some consumers' risk profiles without sufficient documentary evidence just before SCARP transactions; inconsistencies between the consumer's risk profile and investment objectives; insufficient evidence of consideration of the consumer's overall portfolio when determining whether or not the transaction was suitable; inadequate

[322] Financial Conduct Authority, 'FINAL NOTICE to J.P. Morgan International Bank Limited' (2013)
[323] FCA Handbook, Principles of Business 3
[324] FCA Handbook, SYSC 9.1.1R
[325] Financial Supervisory Authority, 'FINAL NOTICE to Credit Suisse (UK) Limited' (2011)

systems and controls in recommending leverage to consumers such that there was no documentation to evidence that CSUK considered whether the use of leverage was appropriate in light of the consumer's attitudes to risk and no documentation showing that the risk associated with use of leverage had been explained; inadequate systems and controls surrounding levels of investment concentration in consumers' portfolios; and failure to effectively monitor its staff to take reasonable care to make suitable advice such as the team leader who was responsible for the sales part having so many people to monitor that effective oversight was not possible.

3.2.2 Regulatory redress actions

In the sanctioned cases described in the previous sections, the regulator has sought redress for consumers' losses from financial institutions' regulatory breach.[326] The compensations were paid not by the regulator's statutory apparatus such as restitution order[327] or consumer redress scheme[328] but by the voluntary agreements with the financial institutions. Except for IRHPs compensation agreements, the contents of voluntary compensation were not publicized. So below will examine how redress for the consumer loss from "mis-selling" of the IRHP was provided.

3.2.2.1 Subject for redress

The regulator decided to seek redress for consumers' detriment from "mis-selling" IRHPs through "voluntary" agreement with the relevant banks. But the FSA limited the consumers for redress to 'non-sophisticated'; for the definition of non-sophisticated, the regulator did

[326] The regulator sought to redress consumers in 6 cases out of 8 sanction cases but the other 2 cases were the ones where loss did not occur to consumers.
[327] FSMA 2000, s 384
[328] FSMA 2000, s 404

not use the existing regulatory concept such as 'retail client'[329] but developed a new 'sophistication test'. The sophistication test deemed as 'sophisticated' a consumer who meets at least two of the following criteria: a) an annual turnover of more than £6.5 million; b) a balance sheet total of more than £3.26 million; c) more than 50 employees.[330] In addition, if the value of IRHP was over £10 million at the time of transaction, the consumer was deemed as sophisticated notwithstanding the result of the 'sophistication test'. In comparison with the 'retail client' of the COBS, the 'non-sophisticated' consumers were much narrowly defined.[331] The consumers classified as 'sophisticated' in the test would have to seek compensation through litigation. The FSA explained that the criteria of the sophistication test came from the Companies Act 2006, which was used to determine whether a company can take advantage of the lighter reporting requirements for small companies.[332]

This narrow definition for non-sophisticated consumers who are eligible for the IRHP loss compensation triggered severe complaints and criticism.[333] It does not make sense to adopt a remote rule of the Companies Act for defining 'non-sophisticated' consumers, instead of the clear concept of 'retail client' in the COBS. However, a close look at the powers granted by the statute to the regulator shows that the narrow definition of non-sophisticated consumers seems to be the result of the limited enforcement options for regulatory redress.

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[329] FCA Handbook, COBS, 3.4.1R

[330] Financial Services Authority, 'Interest Rate Hedging Products Pilot Findings' (2013) 10. However, the sophistication test was amended based on the original version in order to consider the member of a group company and Special Purpose Vehicle company, etc.

[331] COBS defines a professional client in relation to MiFID business as a company meeting two of the following criteria: a) balance sheet total of €20 million, b) net turnover of €40 million, c) own funds of €2 million (See COBS 3.5.2(2))

[332] Financial Services Authority, 'Interest Rate Hedging Products Pilot Findings' (2013)

[333] See eg House of Commons Treasury Committee, 'Conduct and competition in SME lending' (2015) 40-47

The tools the regulator can use to seek redress for the loss suffered by consumers are a restitution order[334], a consumer redress scheme[335] and the FOS[336]. However, in terms of the IRHP "mis-selling", there was practically little tool the regulator could use. A restitution order necessitates the regulator to apply to the court, which requires tremendous administrative work. A restitution order by the regulator itself also needs the regulator to specify all the breaches and compensation amount for each of the 29,568 IRHP cases, which is theoretically possible but practically impossible considering the time and resource constraints of the regulator.

The FOS cannot be used as the major redress tool due to its narrow coverage: consumers with annual turnover less than €2million, fewer than 10 employees; and £150,000 award limit.[337] The most probable tool for the regulator was the 'consumer redress scheme'[338] which was newly adopted by the FSA 2010. But for this scheme, FSA 2010 requires that the case should appear to succeed securing a remedy when it is brought to the court.[339] The majority of consumers of IRHPs consisted of SMEs which are not 'private persons' and so the COBS cannot be applied these cases because only private persons have the statutory "right of action" from regulatory breach by the Section 138D of FSMA 2000.[340] This means that the IRHP cases of SMEs don't seem to easily succeed in securing a remedy in the court because the SMEs should rely on the common law which put much more importance of arm's length principle of contract.[341] As such, a 'consumer redress scheme' was also

[334] FSMA 2000, s 384
[335] FSMA 2000, s 404
[336] FSMA 2000, s 225
[337] Financial Conduct Authority, *FCA Handbook*, Glossary Definition micro-enterprise; Financial Ombudsman Service, 'The Ombudsman and Smaller Businesses' (2014)
[338] See p41
[339] FSMA 2000 s.404(b); see n208
[340] Financial Services Authority, 'Guidance note Consumer Redress Scheme' (2010) 10.2
[341] See Chapter IV section 4.2 and 4.3

not available to the regulator. Without efficient legitimate tool for redress, it is expected that the regulator could not have enough leverage in negotiation with banks. Considering the regulator's constraints above, it can be believed that the dissatisfactory coverage of eligible consumers for voluntary compensation might not come from the regulator's incapability or a surrender to the lobby of the banks.

3.2.2.2 Causation

The FSA announced that IRHP loss of the non-sophisticated consumers caused by regulatory breaches of financial institutions was to be compensated.[342] But it made it clear that the non-compliant sales would not be the subject of compensation when it was reasonable that the consumer would have followed the same course of action, notwithstanding the breach.[343] This shows that causation was an important factor for the regulator to consider in the redress for consumers' loss. However, the causation test by the regulator has its own characteristics which will be explained below.

The regulator's causation test started with the usual question in the causation test in private law, 'would the consumer have taken the same course of action but for the firm's breach?'[344] According to the FSA, for example, if the firm misled a consumer to buy the IRHP by the false explanation of IRHP being the mandatory condition of providing the loan, the answer of the test is "no", and the bank would have to compensate all the losses.[345]

[342] Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' (n 6) 9
[343] Ibid
[344] Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' (n 6) 10
[345] Ibid 16

A difficult situation for answering the test is when a consumer, who made an 'express wish'[346] to hedge the interest rate risk, had not been told by the bank about the risk of the IRHP or the massive break cost. The regulator set out the answer to this question based on its own expectation of the reasonable reaction of a consumer. It assumed and required the bank to assume that the consumer would have selected a simpler IRHP product such as a cap or a plain swap with the break cost less than 7.5% of the nominal amount of IRHP if there was no evidence to the contrary. And the bank had to compensate to the consumer the difference between the purchased one and the simpler IRHP embedded with a 7.5% break cost.[347] One of the characteristics of the above causation test by the regulator is that the regulator assumed its own prospective result (7.5% break cost and a simple product), not sticking only to the 'but for' test.

3.3 Approach by the regulator to enforcement

The previous sections has analysed the disciplinary and redress actions of the regulator against "mis-selling" of over-the-counter derivatives. The analysis of the sanctioned cases provides a snapshot of the approach that the regulator adopts to intervene failures of financial institutions complying with regulatory duties. Following sections will examine the strategy the regulator takes in its intervention.

3.3.1 Focused on group failures

One characteristic of the regulator's disciplinary actions related with "mis-selling" of over-the-counter derivatives is that it has used its powers on large scaled cases. Each of the 8

[346] Ibid 48-51
[347] Ibid

disciplinary actions by the regulator since 2000 involved at least 259 consumers[348] with a maximum of 295,000 consumers[349] (see the Table 1 below). The amount of invested money related with each case ranged from £720 million[350] to £7 billion[351]. The focus on the large scaled cases can be viewed as the regulator's pursuit for maximizing the efficiency of using its resources. It is practically impossible for the regulator with its limited resources to take actions against all breaches in the market place. FSMA 2000 also requires the regulator to 'use its resources in the most efficient and economic way' as one of its regulatory principles.[352]

Table 1: Regulator's sanction against "mis-selling" of over-the-counter derivatives

Financial institutions	Product	Contravention	Year of sanction	Fine (A) (£)	Number of related consumers	Invested amount (million £) (B)	Ratio (A/B) (%)
Chase de Vere Financial Solutions	structured capital at risk products	misleading communication	2003	165,000	259	No information	
Lloyds TSB Bank	structured capital at risk products	unsuitable products	2003	1,900,000	51,000	720	0.26
Credit Suisse UK	structured capital at risk products	unsuitable products	2011	5,950,000	623	1,099	0.54
Savoy Investment Management	investment advice	suitability procedures breach	2012	412,000	4,000	No information	
Santander UK	structured capital at risk products	misleading communication	2012	1,500,000	178,000	2,700	0.06
J.P. Morgan	investment advice	suitability procedures breach	2013	3,076,200	3,000	No information	

348 Financial Services Authority, 'Final Notice to Chase de Vere Financial Solutions plc' (2003)
349 Financial Conduct Authority, 'Final Notice to Santander UK plc' (2014)
350 Financial Services Authority, 'Final Notice to Lloyds TSB Bank plc' (2003)
351 Financial Conduct Authority, 'Final Notice to Santander UK plc' (2014)
352 FSMA 2000, s.3B(1)(a)

Financial institutions	Product	Contravention	Year of sanction	Fine (A) (£)	Number of related consumers	Invested amount (million £) (B)	Ratio (A/B) (%)
Santander UK	structured capital at risk products	unsuitable products	2014	12,377,800	295,000	7,000	0.18
Credit Suisse International	structured deposit	misleading communication	2014	2,398,100	83,777	797	0.30

(Source: FSA/FCA final notices since 2000 related with sales of over-the-counter derivatives)

3.3.2 Financial penalty as a major coercive tool

The regulator has various coercive tools for enforcement including public censure, financial penalties, suspending permission, restitution order and cancelling a permission, but Table 1 shows that it has used financial penalties as its major regulatory arms for wrongdoers.

However, the effectiveness of financial penalty as a deterrent tool raises a question. The Table 1 shows the financial penalty imposed on financial institutions which "mis-sold" over-the-counter derivatives. It was maximum 0.54% and minimum 0.06% compared with the volume sold. Even though the exact margin of financial institutions cannot be obtained, this amount of fine below 1% of the transacted volume would be short of the commission financial institutions earned through the penalized behaviour. For instance, the margin a bank earned from selling an IRHP to a retail client was 4.48%.[353]

In fact, the insufficient deterrent effect of imposed fines had led the regulator to adopt a new framework to calculate fines in 2009.[354] However, the Table 1 above shows that the new framework may still not be enough for full deterrence. This can be, at least partly,

[353] *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc* [2013] EWHC 3167. The bank sold interest rate swap worth £2 million and earned £89,500 (4.48%) as commission without disclosure.

[354] Financial Supervisory Authority, 'FSA proposes bigger fines to achieve credible deterrence' (2009) <http://www.fsac.org.uk/library/communication/pr/2009/091.html> accessed 17 February 2016

because of various 'mitigating factors'[355] and 'settlement discount'[356] in settling the amount of financial penalty, even though those discounting factors are believed to be necessary to facilitate cooperation from the penalized financial institutions during the investigation and enforcement process. Actually, in 7 cases out of 8 sanctioned cases above (the exception was the Santander 2012 sanction case), the penalized firm received 30% discount of fines based on the 'settlement discount'. Sanctions by the regulator also cause reputational loss to the penalized firms. However, reputation loss may not be substantial enough for salespersons who pursue their personal interest and even the management who are attracted more to the short term performance.[357]

3.3.3 Voluntary compensation scheme

Disciplinary actions and redress are both important for the regulator to meet 'the consumer protection objective'. Disciplinary action deters future similar bad behaviours. Redress can be the imminent method of protecting consumers by providing compensation for the loss the consumers suffer. Especially, considering the burdensome expenses of the litigation for redress[358], the regulator's action for compensation has more important meaning to suffered consumers. FSMA 2000 provided the regulator with the power to seek redress for the loss suffered by consumers through 'restitution order', which can be executed by the court[359] or the regulator itself,[360] or 'consumer redress schemes'[361].

[355] Financial Conduct Authority, *FCA Handbook*, DEPP 6.5A.3
[356] Financial Conduct Authority, *FCA Handbook*, DEPP 6.5A.5
[357] Alessio M.Pacces (n68) 484
[358] See House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n333) 163
[359] FSMA 2000, s 382
[360] FSMA 2000, s 384
[361] FSMA 2000, s 404

However, the regulator has never used this official redress power in the "mis-selling" cases of over-the-counter derivatives; instead, they depended on the penalized financial institutions' "voluntary compensation" agreement, which means that the firms who contravened regulatory duties agreed with the regulator to compensate on their own the loss of consumers from their breach. The biggest reason for adopting this unofficial measure can be its swift and less complicated procedures. The chairman of FCA explained the rational of voluntary compensation in dealing with the IRHP "mis-selling" scandal:

> I think that if we, as a regulator, are to do mass redress schemes, of which this is classically one, we have two ways of doing it. Either we go through the law courts, which takes a very great length of time and costs a very great deal of money, or, as a proactive regulator, we go out on the front foot and say, "This is how we are going to do it", and the necessary part of "this is how we are going to do it" is coming to an arrangement with the banks that is "voluntary", or at least contractually voluntary, to do it that way. If they refuse, we end up in the law court and we get into a PPI-type situation. [362]

It can be admitted that the voluntary compensation scheme is an effective and pragmatic method to relieve consumers' detriment in a swift and economic way on both sides. But before the IRHP scandals, the process the regulators took lacked transparency. In all the voluntary compensation cases of over-the-counter derivatives "mis-selling", there were only short comments in the final decision documents by the regulator saying that the financial institutions sanctioned agreed to compensate the consumers who suffered loss from their wrongdoing. No information about the voluntary compensation criteria and

[362] House of Commons Treasury Committee (n 358) 37

process was publicized nor provided to consumers, such as the criteria for selecting eligible consumers for compensation and calculating the compensation amount.[363]

Recently, the opaqueness of the voluntary compensation agreements became the social and political hot issue in dealing with IRHPs. With the parliament's continuous critics[364] and consumers' structured resistance[365], the FCA had to make public the contents of the voluntary compensation agreements with the banks regarding the IRHPs.[366]

Information on the detailed criteria and process of voluntary compensation should continue to be publicized "voluntarily" in the future for other "mis-selling" cases. Without the information on compensation criteria and process, the consumer who claims loss as a consequence of "mis-selling" by a financial institution cannot determine whether he has been compensated fairly and so has no choice but to accept the compensation offer by the firm. This could lead to another failure of consumer protection. With the information about the compensation agreement, the consumers can monitor the financial institution's compensation activity.

Conclusion

This Chapter, firstly, answered the question how regulation in financial services sector has been evolved. It examined the drivers and major changes in each legislation from the advent of financial regulation in 17th century to the recent FSA 2012. This examination illustrated that "failures" for both the market and regulation to deal with the changed

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[363] The opaqueness of voluntary compensation is also in other financial services areas than over-the-counter derivatives. See Christopher Hodges, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics* (Bloomsbury Publishing 2015) n 92

[364] House of Commons Treasury Committee (n 358) 47

[365] See eg Bully-Banks was created in December 2011 by business owners each of whom had been mis-sold Interest Rate Hedging Products. <http://www.bully-banks.co.uk/site/> accessed 15 May 2015

[366] Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' (A letter to relevant banks) (2012)

financial environments have been the impetus to bring about the paradigm-shifting legislative transformation.

In the modern era, The PFI Act was enacted to tackle the increasing fraudulent promotions of unit trusts and shares as the general public started investing in financial products from 1930s. The FSA 1986 was the legislative response to the expansion of financial services industry. From 1970s, the collapse of the Bretton Woods system of fixed currency rates and the advent of Black-Scholes option pricing model which could estimate the fair price of financial derivatives made the financial services market expand dramatically in types of products and services provided. FSA 1986 replaced PFI Act which was literally aiming just prevention of fraud, in order to effectively cope with the expanded and complex financial services market.

FSMA 2000 was legislated to keep the pace with the trend of integration of different financial services sectors. As one financial institution could do business in many different financial services sectors, the regulatory framework of the FSA 1986 which separately regulated different financial services sectors became more and more obsolete and inefficient. The global financial crisis revealed, again, the weaknesses of the FSMA 2000 of neglecting financial stability and consumer protection and resulted in enactments of FSA 2010 and FSA 2012, both of which attempted to remediate the failures. In briefly summarizing the above history, financial regulation is the product of evolution, the result of financial regulation facing challenges from changes of financial environments and adapting itself to the new environments.

Secondly, this Chapter examined the current regulatory requirements particularly related with transactions of over-the-counter derivatives. This illustrated that current regulatory duties on financial institutions are not only fair disclosure in order to help consumers make informed decision but also provision of suitable advice in order to protect consumers from self-harming behaviours. This part of the Chapter illustrated that financial regulation has evolved from "duty to disclosure" to "duty to act" to "duty to protect consumers from themselves". It showed that the direction of evolution of financial regulation has been from consumer self-protection to paternalistic protection. This evolutionary direction has been supported by behavioural science and continuous occurrence of consumer detriments in the financial services sector.

This Chapter, lastly, examined the regulator's actual disciplinary actions related with "mis-selling" of over-the-counter derivatives. Doing so has provided opportunities to understand what approach the regulator takes when taking disciplinary actions. This showed that the regulator, for using its resources efficiently and economically, tends to focus on financial institutions' large-scaled failures for consumer protection in terms of the number of related consumers and the volume of amount invested. And it was also found that financial penalties, the disciplinary tool most commonly used, are not enough to remove all the profits the financial institutions might earn through the penalized "mis-selling" and have questionable effect of deterrence. In the area of regulatory compensation, this Chapter showed that the regulator prefers "voluntary redress scheme" for its swift and economic process. However, it was pointed out that the opaqueness of the voluntary scheme should be corrected.

CHAPTER IV. PRIVATE LAW ON OVER-THE-COUNTER DERIVATIVES TRANSACTIONS

Introduction

The previous Chapter examined how regulation has been developed and enforced to regulate the "mis-selling" of over-the-counter derivatives. The aim of this Chapter is to understand the approach of private law in dealing with claims of "mis-selling" of over-the-counter derivatives.

The court intervenes in over-the-counter derivatives transactions when the counterparties of a contract litigate to seek to recover damages from the transaction. In such a litigation, the focus of the court is on allocation of rights and liabilities between parties and is not extended to any inherent policy such as needs to be advanced by any attendant regulatory regime or 'instrumental values'.[367] But financial institutions incorporate the court's decisions in their over-the-counter derivatives sales practice to avoid judicial liability and so the court can be said to contribute in shaping the business standard of financial institutions.[368] This ex-ante function of private law to set standards of acceptable conduct to shape behaviour in private relations is an important one and constitutive of a market place.

This Chapter identifies and discusses four major issues in relation to litigation of claiming "mis-selling" of over-the-counter derivatives. One representative case is chosen to provide the vivid picture in which disputes arise between financial institutions and consumers. Then for each issue picked up, relevant cases will be further examined to deduce the principles

[367] Julia Black, 'Law and Regulation: The Case of Finance in Regulating Law' in Christine Parker, *Regulating Law* (OXFORD 2005) 41
[368] Péter Cserne (n 258) 89

on which private law ordering is made. The summary of relevant decided cases is provided in a concise form in the Table 2.[369]

4.1 Major issues in private law

The "mis-selling" cases, where consumers alleged that they were misled to enter into over-the-counter derivatives contracts, were brought to the court from the 1990s in the UK. Although each case has its own different circumstances in which the disputes arose, there were four main issues that were common in those cases: 1) a duty of care imposed on financial institutions, 2) misrepresentation by financial institutions, 3) application of regulatory rules to financial institutions and 4) causation. Before examining these four issues, by looking at an example case in detail, the nature of each issue can be better understood. The example is the *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc*.[370]

4.1.1 An example case

The claimant was Titan Steel Wheel ("Titan") which was a manufacturer of steel wheels for vehicles. Its income was earned predominantly in euro because the majority of its products were sold in the European continent, while its costs were incurred in sterling. So it was exposed to significant exchange rate risk. In order to cope with the risk, it purchased structured over-the-counter derivatives from the Royal Bank of Scotland ("RBS") in 2007.

In February 2007, Titan purchased three structured products of euro/sterling swaps from the RBS to hedge its exchange rate risk. The basic structures of all three products were the same. If the actual currency rate at the end of a month is above "the upper rate" (1.478 euro/pound), Titan could sell a certain amount (1.65 million) of Euro at "the upper

[369] See p107
[370] [2010] EWHC 211

rate" (profit situation). If the actual rate at the month end went down below the lower rate (1.45 euro/pound), Titan should sell twice the amount (3.3million) of euro at "the upper rate" (loss situation). If the spot currency rate was between the upper and lower rate, Titan had no obligation or right to sell Euro. In other words, Titan protected itself against the risk of the Sterling strengthening above "the upper rate" but for the price of protection, it had to hold the risk of loss when the exchange rate went down below the lower rate.

As the euro/sterling currency rate happened to go down below the lower rate slightly after the purchase of the February currency swaps, both parties started to have discussions about restructuring the deals from mid-April. Discussion was mainly done between the financial controller of Titan and the RBS's corporate treasury manager. After a couple of months of discussions, in June 2007 they restructured the February deals into a single contract with changes to the upper and lower rates and other minor conditions. In the restructured deal, "the upper rate" was changed from 1.478 to 1.467 and "the lower rate" from 1.4500 to 1.4285, and the contracted amount increased from €1.65 million to €2 million. Although the closing out of the previous deals cost about €180,000 to Titan, this fact was not raised or reported to Titan by RBS before the restructured deal was executed. This cost was carried forward into the restructured deal.

In September 2007, RBS sent an e-mail containing a proposal for a new swap product which was more speculative. This product had a condition of an 'accrual rate', which was such that when the spot currency rate went over the accrual rate, Titan could sell 0.5 million euro at the accrual rate, while when the currency rate went below the accrual rate, it should sell 1 million euro at the accrual rate. In addition, there was a 'knock-out' condition under which the deal would be terminated when the profit Titan earned on the deal became more than 10 cent per euro.

The key differences between the September deal and the June deal were two things. Firstly, the probability of loss to Titan increased dramatically because it had to bear loss just when the spot rate goes down below the 'accrual rate' not the "lower rate". Secondly, with the profit cap, the profit Titan might earn from this swap deal was limited while the loss it could have to bear was unlimited.

After a couple of discussions with RBS, Titan decided to purchase the September product when the spot rate of euro/sterling was 1.44 in September 2007. However, the euro/sterling rate started tumbling down from November 2007 and reached the historical low point of almost 1.0 at the end of 2008.[371] As a result, Titan suffered a huge loss.

4.1.2 Major issues

Over-the-counter derivatives are one of the financial products which have manifest imbalance of knowledge and expertise between financial institutions and consumers.[372] So selling over-the-counter derivatives usually involves a series of explanations and discussions between the financial institution and the consumer in terms of the needs of the consumer and the characteristics of the product. The Titan case exemplifies very well the complex structures that over-the-counter derivatives have, how those products are marketed and how communication between the two parties proceeds.

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[371] European Central Bank <https://www.ecb.europa.eu/stats/exchange/eurofxref/html/eurofxref-graph-gbp.en.html>

[372] See Chapter II 2.2.3

In general, when an alleged "mis-selling" of over-the-counter derivatives case is brought to the court, the consumer usually claims that he was "advised" to enter into the contract and the financial institution breached the duty of care as an adviser. Here the first issue arises: what is the duty of care imposed on the financial institution which sells over-the-counter derivatives?

The consumer also usually contends that the financial institution misrepresented on the risk or the material characteristics of the over-the-counter derivatives and they were misled to enter into the contract. Here arises the second issue: what kind of communication can be seen as misrepresentation in the transaction of over-the-counter derivatives?

Thirdly, consumers allege that they have a statutory "right of action" for breach of regulatory duty of financial institutions, the right granted by the FSMA 2000[373]. The third issue is about the application of this "right of action": who are entitled with this statutory "right of action" and how is this right applied to the civil cases?

Lastly, if breach of private law standards or regulatory rules is found, the consumer should prove that his loss in over-the-counter derivatives transactions is caused by the breach in order to obtain compensation. The dispute in this issue is what is required for the claimant to prove the causation. The discussion below explores these issues through relevant decided cases and thus helps develop understanding of the approach of private law towards these issues.

4.2 Duty of care

[373] FSMA 2000 s 138D (6); FSMA 2000 s 150

In claiming negligence of financial institutions in over-the-counter derivatives transactions, the first dispute is the question about the extent of any "duty of care" that is owed by the seller of the over-the-counter derivatives; more specifically whether the financial institution has a duty of care as an advisor. The court's view about the duty of care of an advisor is wide ranging and onerous; an advisor's duties include knowing the consumer's investment objectives and attitudes to risks, presenting investment opportunities in accordance with such objectives and risk attitudes, informing the consumer of accurate prices of the investment and taking care of the consumer's investment diversity.[374] Whether the seller of over-the-counter derivatives is an advisor or not is decisive in defining the duty of care of the seller in private law. So this is one of the fiercest battle fields in disputes of "mis-selling" of over-the-counter derivatives between financial institutions and consumers.

4.2.1 Existence of advisory relationship

Case law of the "mis-selling" of over-the-counter derivatives shows that the court consistently uses contractual terms as the prime criteria for deciding the existence of an advisory relationship. This is in line with the principle in common law that if the parties have contractually agreed on how to transact, then the agreement will establish the scope of responsibility and duty of the parties.[375]

Decisions of courts regarding the existence of advisory service are based on the following propositions. Firstly, the court differentiated the "legal" advisory relationship from the "factual" one.[376] It proposed that the legal relationship between the financial institution and the consumer was dependent on contractual terms and it could not be affected by

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[374] Alastair Hudson, *THE LAW OF FINANCE* (n 90) para 25-35; See eg *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186 [616]

[375] *Henderson v Merrett* [1995] 2 AC145; George Walker, Robert Purves, and Michael Blair QC (n 106) para.7.11

[376] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133 [73](1)

the factual relationship.[377] Secondly, the contract of providing advisory service is a significant factor indicating there is an advisory relationship.[378] On the contrary, the absence of the contract for advisory service can mean that there is no advisory obligation on financial institutions.[379] Thirdly, financial institutions and consumers can make contracts defining their relationship so that they can optimize allocation of transaction-related risks between the two parties.[380] So contractual terms can define the obligation and right of each party in the transaction.[381] Lastly, the contractual terms allocating the obligation and right of the two parties prevent one party from asserting a claim based on an actual reality which is different from the contractual terms agreed.[382] This means that the consumer who agreed a contractual term stipulating that the financial institution does not provide advisory service cannot assert that he was provided with advisory service and relied on that.[383] The contract provides contractual estoppel.

In the example case of *Titan Steel Wheels Ltd v The Royal Bank of Scotland Plc*, all of the contractual documents described that the bank would not provide advisory services and any opinions expressed by the bank should not be treated as advice.[384] The court declared that it had no reason to interpret the contractual terms in other ways. The court's position was that 'a person who signs a document knowing it is intended to have a legal effect is

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[377] *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm) [544]
[378] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133 [73](2)
[379] *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186 [440]
[380] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133 [73](3)
[381] *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186 [475]
[382] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133 [73](4)
[383] See eg *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm) [544]; *Peekay Intermark Limited, Harish Pawani v Australia and New Zealand Banking Group Limited* [2006] EWCA Civ 386 [56]
[384] [2010] EWHC 211 [78]-[83]

generally bound by its terms there.'[385] The court also supported its decision by showing that there was no fee paid to the bank for advice and no request for advice by Titan.[386]

In the case of *Bankers Trust International plc v Dharmala Sakti Sejahtera,* the court also rejected the bank's duty as an advisor in that: Dharmala did not ask the financial institution to be an advisor; Dharmala held itself out as having substantial capability to understand and evaluate investment proposals for itself. [387]

Contractual terms of disclaiming advisory service estopped an unsophisticated individual person from asserting advisory relationship as well. *Green & Rowley v The Royal Bank of Scotland Plc* [388], one of the recent interest rate hedge product cases, showed that this disclaimer can prohibit individual consumers from claiming on a negligent advice. The consumer, the owner of a small hotel, claimed that he had been recommended and pushed by the bank to enter into the swap, while the bank denied any recommendation and insisted that it provided only information about some different interest rate hedge products. The court referred to the disclaimer provision in the contractual documents stating that the bank would provide the consumer with an execution-only service and that the bank would not provide the consumer with advice.

The *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc* [389] illustrates very well the importance of the clause defining the scope of the contract. The court accepted that the bank, in reality, provided advice about interest rate hedge products, and stated that the advice given was a negligent one; however, it adjudicated that it was

[385] Ibid [88]; *L'ESTRANGE V GRAUCOB* [1934] 2 KB [394]
[386] *Titan Steel Wheels Ltd v The Royal Bank of Scotland Plc* [2010] EWHC 211 [94]
[387] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518
[388] *Green & Rowley v Royal Bank of Scotland plc* [2012] EWHC 3661
[389] [2014] EWHC 3043 (Ch)

not breach of a duty of care and so not actionable because of the disclaimer clause denying to provide advisory service.

Where a financial institution did make a contract of providing an advisory service, it was free from the liability of negligent advice by *an exclusion of liability clause*. *In Camerata Property Inc v Credit Suisse Securities (Europe) Ltd*,[390] the advisory service agreement included a provision stipulating that the financial institution would be liable only for 'grossly negligent' advice. The court held, accepting the effect of this disclaimer, that the financial institution would be liable only under the condition of 'gross negligence' which the court defined as a higher level of negligence.

4.2.2 Low level duty of care

Then under the non-advisory service relationship, what kind of a duty of care would be held by financial institutions selling over-the-counter derivatives? The court, in *JP Morgan Chase Bank and Others v Springwell Navigation Corporation*,[391] analysed that the service the financial institution had proffered was not advice nor mere execution-only service. Even though there was no contractual clause of "advice" being provided, the court accepted that personal recommendations or advice was given in reality. In such circumstances, the court stated that the financial institution held a 'low level duty of care' which required 'not to make a negligent misstatement' or 'to use reasonable care not to recommend a highly risky investment' without warning risks.[392] This concept of low level of a duty of care was in line with the duty, acknowledged earlier in *Bankers Trust*

[390] *Camerata Property Inc v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm)
[391] *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186
[392] Ibid [108]

International plc v PT Dharmala Sakti Sejahtera,[393] not to carelessly mistake facts and has been adopted in other descendent cases.[394]

4.3 Negligent misrepresentation

Negligent misrepresentation is another major issue in claims of "mis-selling" of over-the-counter derivatives. Before delving into the individual cases, it is necessary to understand the legal concept of misrepresentation, which forms the baseline in decisions of the court in disputes of over-the-counter derivatives. There are some necessary components constituting misrepresentation. Firstly, it should be a representation about a fact rather than an opinion.[395] Secondly, it should be false.[396] Mere lack of clarity or ambiguity in representation does not make it a misrepresentation.[397] Thirdly, an omission of explanation is not usually deemed a misrepresentation.[398] Lastly, the representation must have induced the consumer to do the transaction.[399]

There are two legal grounds for alleging negligent misrepresentation: misrepresentation in tort and misrepresentation under the Misrepresentation Act 1967. In common law, Hedley Byrne v Heller[400] introduced, for the first time, negligent misrepresentation and with other following cases set up the principles for negligent misrepresentation.[401] The claim based on The Misrepresentation Act 1967 is not largely different from what is required in tort

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[393] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518 p573

[394] *Bank Leumi (UK) plc v Wachner [2011] EWHC 656 (Comm)* [196], [197]; *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc* [2014] EWHC 3043 (Ch) [81] ; *John Green and Paul Rowley v The Royal Bank of Scotland Plc* [2012] EWHC 3661 [82]; *Thornbridge Limited v Barclays Bank Plc* [2015] EWHC 3430 [125]

[395] The Law Commission and the Scottish Law Commission, *A joint consultation paper: Consumer Redress for Misleading and Aggressive Practice* (Law Com No 199, 2011) para 5.11-5.12

[396] Ibid, para 5.10

[397] Ibid

[398] Ibid, para 5.13

[399] Gerard McMeel and John Virgo, *Financial Advice and Financial Products* (3rd ed, OXFORD, 2014) para 6.06

[400] *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465

[401] Kirsty Horsey and Erika Rackley, *Tort Law* (Oxford 2013) 181-193

except for in two aspects: 1) it has no need for the existence of a duty of care which is necessary in the tort misrepresentation; 2) the burden of proof, once misrepresentation is accepted, is shifted to the defendant who should prove that 'he had reasonable ground to believe and did believe up to the time the contract was made the facts represented were true'.[402]

The allegations of misrepresentation in the "mis-selling" of over-the-counter derivatives whether based on the tort or Misrepresentation Act 1967 can be classified mainly into three areas: market prediction; explanation of risks; and disclosure of fees. Below will examine each area in over-the-counter derivatives transactions.

4.3.1 Market prediction

One of the major causes for claims of misrepresentation in the transaction of over-the-counter derivatives is the mis-prediction of underlying asset price or index by the financial institutions. On this point, the court's position has been that it does not recognize any liability from wrong market prediction in hindsight.

Firstly, the contractual term stating "no representation" and "no reliance" made the court to adjudicate no misrepresentation. In *JP Morgan Chase Bank and Others v Springwell Navigation Corporation,* [403] the claimant bought from JP Morgan notes referenced to the bonds issued by the Russian Federation and the notes were embedded with currency forward contracts. But the referenced Russian bonds were defaulted upon and the claimant suffered a huge loss. According to the claimant, JP Morgan made misrepresentations that the Russian economy was strong and there would be no default on Russia's debt

[402] Misrepresentation Act 1967, s.2; Gerard McMeel and John Virgo (n 399) para 6.18
[403] [2008] EWHC 1186

obligations. By the way, the contract between the two parties stipulated that 'no representation or warranty express or implied was made by CMB [the bank], and conversely, that by signing the letters, Springwell "By placing an order" with CMB expressly represented that…it had independently, without reliance on CMB made a decision…'[404]

The court also explained that the statement about the Russian economy was not a factual comment but the sales person's opinion which did not constitute "misrepresentation". It adjudicated that whether this was an opinion or a factual statement, the contract denying the consumer's receiving any representation and relying on that barred the consumer to pursue allegations of misrepresentation. In addition, the court added, through analysing the record of the conversations between the two parties, that the claimant was not influenced by the alleged misrepresentation because the claimant still believed that the fundamentals of Russian economy was not strong and so the "misrepresentation" was not actionable anyway. In other cases such as *Grant Estates Limited v The Royal Bank of Scotland Plc*[405] where the claimant alleged the bank's "misrepresentation" about the interest rates rise to the contrary of the dramatic fall later and *Standard Chartered Bank v Ceylon Petroleum Corporation*[406] where the consumer alleged to be misled by the bank's "misrepresentation" that the oil-related over-the-counter derivatives were for hedge when they were actually very speculative, the contractual terms stating non-representation and non-reliance estopped the consumers from arguing misrepresentation.

Secondly, the court concluded that a financial institution did not hold any duty to explain or brief all the available market expectations, especially when the consumer did not ask to

[404] Ibid [670]
[405] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133
[406] *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm)

do so. In *Bankers Trust International plc v PT Dharmala Sakti Sejahtera*,[407] the salesperson relayed to the customer a forecast on US six-month LIBOR made by one of the financial institution's economists. This forecast was one of the lowest among many other market experts' opinions. A lower US LIBOR meant that the swap recommended by the financial institution would be more profitable to the customer at maturity. The court ruled that the provision of the lowest forecast of US LIBOR could not be a cause for complaints; the forecast presented did not purport to represent the forecasts of economists as a whole and the fact that the forecast by the economist was low compared with the majority of other economists did not mean that the forecast was unreasonable. It also added that the financial institution was not asked to give the general market forecast by the claimant and had no duty to do so.

4.3.2 Explanation of risks

Another claim of misrepresentation in the over-the-counter derivatives transactions is that financial institutions did not explain or even hid critical risk factors. One of the private law principles related with this issue is again contractual estoppel. The court's primary position is to respect the contractual provisions excluding any liability of representation. *Peekay Intermark Ltd and another v Australia and New Zealand Banking Group Ltd* is an obvious example for this.[408] The consumer was misled by oral explanation saying that the product recommended would be Russian government bonds while not saying that the product was a financial derivative and the investor would not have any control of the way in which the investment was liquidated. The claimant decided to invest in this product relying on the wrong oral explanation, but the bank sent a contractual document where the true

[407] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518
[408] [2006] EWCA 386

characteristics of the product was written. The consumer did not read the document and returned it with his signature to the bank, which included:

> *You should also ensure that you fully understand the nature of the transaction and contractual relationship into which you are entering… The issuer assumes that the customer is aware of the risks and practices described herein, and that prior to each transaction the customer has determined that such transaction is suitable for him*.[409]

While the trial court upheld the claim of misrepresentation, the court of appeal rejected it. It emphasized that the contractual document the party signed, whether he read it or not, bound him and estopped from asserting that he was induced to enter into the contract by pre-contractual statements.

When an incorrect factual explanation about over-the-counter derivatives is provided to the consumer, it is an actionable misrepresentation only when it does influence the consumer's decision of entering into the contract. In JP Morgan Chase Bank and Others v Springwell Navigation Corporation, the court accepted that in terms of Ukraine bonds, JP Morgan made a factually wrong representation that Ukraine had no foreign debt at that time when this was not the case, but did not hold that that misrepresentation was actionable because it judged that the claimant was not induced to enter into the transaction by the misrepresentation.[410] The analysis of telephone conversations between the parties convinced the court that the consumer was attracted to the Ukraine bond because of its potential high yield and decent price and so he would have still invested in the bond even if he had been informed of the exact amount of Ukraine foreign debt.

[409] Ibid [55]
[410] [2008] EWHC 1186 [715]-[723]

The decision that an actionable misrepresentation needs actual inducement is also found in *Bankers Trust International plc v PT Dharmala Sakti Sejahtera*[411]. The consumer entered into an interest rate swap with the financial institution which did not explain the condition that unlimited loss would occur if the US LIBOR became higher than a certain level, while it highlighted the advantages and profits when US LIBOR stayed at relatively lower levels. The court distinguished the question of whether there was misrepresentation from whether the client was misled by the misrepresentation, and it judged that only when the consumer was misled by the misrepresentation could he demand for damages from the over-the-counter derivatives contract.

In recent litigation of interest rate hedge products, the "inducement" ingredient of the "misrepresentation" about the break cost that would occur when terminating the swap contract before maturity was raised. In *John Green and Paul Rowley v The Royal Bank of Scotland Plc*,[412] the bank had explained to the consumer, before entering into the 10 year matured interest rate swap contract in 2005, about the break cost that 'there could be a cost or a benefit to the customer depending on market conditions'. When realizing the break cost was ￡138,650 (27.7% of the debt principal) in 2009, the consumer claimed that the bank's explanation on the break cost was a negligent mis-statement. But the court rejected this claim in that: the bank's explanation that there could be a cost or benefit depending on the market condition was not unfair nor misleading and the consumer could have sought more explanation about the break cost from the bank but did not; most importantly, it was not likely to the court that even detailed information about the break cost would have prevented the consumer from entering into the swap.

[411] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518
[412] *John Green and Paul Rowley v The Royal Bank of Scotland Plc* [2012] EWHC 3661

The court also expressed that the financial institutions did not have any duty to make sure that the consumer did understand the meaning of its representation. In another case related with interest rate hedge products, *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc*,[413] over-hedge became the issue of the dispute. The bank sold a 10-year matured swap to a small family-operated company for hedging a 5-year matured loan with no renewal guarantee. The bank sent an e-mail which mentioned that the swap had 'a 10-year commitment and the bank only has a financing commitment for 5 years.'[414] The court stated that the bank's explanation of over-hedge in maturity was 'brief but not inaccurate or misleading'. It reasoned that the bank did not have a duty to 'take adequate steps to ensure the consumer had an adequate understanding of the full range' of product characteristics.[415]

4.3.3 Disclosure of costs

Undisclosed costs in over-the-counter derivatives are another frequently raised claims of misrepresentation. It has been market practice for financial institutions to earn their commission through the bid-ask spread which is negative (to end-users) mark-to-market value of over-the-counter derivatives rather than to charge its commission separately.[416] When consumers are not informed of the charged commission by bid-ask spread and happen to find out about it later, they are likely to allege that the non-disclosed commission is misrepresentation. However, private law does not recognize the seller's legal obligation to disclose negative mark-to-market value to the other counterparty in over-the-counter derivatives contracts.

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[413] *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc* [2014] EWHC 3043 (Ch)
[414] Ibid [161]
[415] Ibid [156]
[416] See n46

The first litigation in which a claim against non-disclosed negative value of over-the-counter derivatives was *Bankers Trust International plc v PT Dharmala Sakti Sejahtera*,[417] and the decision in this case has been referred by other cases afterwards. In relation to two interest rate swaps worth $50 million transacted with Dharmala, the financial institution charged $10 million through the uninformed negative mark-to-market value. On this issue, the court concluded that the financial institution was not obliged to disclose the mark-to-market value without any positive representation or undertakings to inform.[418]

The issue of the non-disclosed negative mark-to-market occurred again in the recent interest rate swap scandals. Nextia Properties, which was a small company in the property development business, entered into an interest rate swap with National Westerminster Bank in March 2008.[419] The bank's salesperson suggested to Nextia three alternatives for hedging, which were a swap, a cap and a collar; from the side of the consumer, the swap was a fixed interest rate in exchange for a floating base rate, the cap setting the maximum interest rate and the collar providing a band of interest rate. The cap and the collar provided benefits to the consumer in that the consumer would enjoy the low interest rate when the interest rate goes down while providing protection against rising interest rate. The salesperson explained that there was an upfront payment premium for the cap and the collar which were respectively ￡50,330 and ￡5,062, but that the swap had no cost or fee. The consumer selected the swap, attracted to the "no cost" condition. However, the mark-to-market value of the swap on the day of execution was negative ￡89,500 to the consumer and the same amount positive to the bank. The consumer bought the swap

[417] [1996] C.L.C. 518
[418] Ibid p554
[419] *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc* [2013] EWHC 3167

without knowing the negative mark-to-market value. The court referred to the above *Bankers Trust International v Dharmala* and ruled that there was no obligation to disclose mark-to-market value. It added that the contract between the consumer and the bank made it clear that the contract was agreed at arm's length of each counterparty.

4.4 Regulation in private law

4.4.1 Reference to statutory regulation

In general, the private law has an approach that statutory regulation can be a criteria in deciding whether a financial institution exercises appropriate 'skill and care' when doing business.[420] In *Shore v Sedgwick Financial Services Ltd*, the court stated that regulatory requirements could be the start in determining the extent of duty of financial institutions.[421] The non-compliance by a financial institution of relevant regulatory rules can be seen as a failure of exercising proper 'skill and care'.[422] But the court does not allow the regulation to override the private law when the requirements of both collides.

In *Green & Rowley v Royal Bank of Scotland plc*, the court stated that regulatory rules related with providing advisory service such as the suitability rule could be applied to the advisory relationship between a financial institution and a consumer,[423] but that those rules could not be applied to outside of an advisory relationship.[424]

In terms of representation, the regulatory rule, COBS, requires financial institutions to take reasonable steps to communicate fairly and clearly.[425] However, the court, in *Green & Rowley v Royal Bank of Scotland plc*, stated expressly that this fair and clear communication

[420] Alastair Hudson, *THE LAW OF FINANCE* (n 90) location 26623 (Kindle edition)
[421] [2008] PNLR 244 [161]
[422] *Loosemore v Financial Concepts* [2001] Lloyd's Rep PN 235 , 241
[423] [2012] EWHC 3661 [82]
[424] Ibid [109]
[425] FCA Handbook, COBS 4.2

duty in regulation was beyond the common law duty of representation, which was 'not to mis-state' and thus rejected the claim that this regulatory communication rule was encompassed in the common law duty.[426]

4.4.2 Right of action of private person

FSMA 2000 expressly entitles a 'private person' with a "right of action" for his loss from financial institutions' breach of regulation, describing that 'A contravention of a rule by an authorized person is actionable by a private person who suffers loss as a result of the contravention…' [427] The Financial Services and Markets Act 2000 (Right of Action) Regulations 2001 defines, by the power delegated by FSMA 2000[428], the 'private person' as 'any individual' and 'any person who is not an individual, unless he suffers the loss in question in the course of carrying on business of any kind'.[429] A "rule" here means the regulation created by financial authorities such as the FCA, so the COBS is one kind of this "rule". This means that a private person who suffered loss from breach of the COBS by financial institutions can show in the court that the financial institution did breach the COBS[430] rather than having to rely on the breach of common law duty,[431] even though it does not mean being automatically capable of giving rise to obligations or compensation[432].

[426] *Green & Rowley v Royal Bank of Scotland plc* [2012] EWHC 3661 [82]
[427] FSMA 2000, s138D (2)
[428] FSMA 2000, s138D (6)
[429] Financial Services and Markets Act 2000 (Right of Action) Regulations 2001, 2001 No.2256, s3
[430] Nevertheless, it does not limit the action of a person from the other common law cause.
[431]Andrew Davis, '*Halsbury's Statutes*' (2013) <https://www.lexisnexis.com/uk/legal/results/enhdocview.do?docLinkInd=true&ersKey=23_T23647453338&format=GNBFULL&startDocNo=0&resultsUrlKey=0_T23647459875&backKey=20_T23647459876&csi=282943&docNo=3> accessed 9 March 2016
[432] Department of Trade and Industry, *Defining the private investor: a consultative document* (1990) para 2.1 ; *R v Financial Services Authority* [2011] EWHC 999 (Admin) [71]

Titan Steel Wheels Ltd v The Royal Bank of Scotland plc [433] was the first case among over-the-counter derivatives disputes, where a non-individual consumer claimed the "right of action" that FSMA 2000 provided. In the interpretation of the phrase of 'in the course of carrying on business of any kind', Titan claimed that the currency swaps it entered into were 'merely sporadic and intermittent activity fully outside the course of its business'.[434] However, the court ruled that Titan entered into the currency swap in the course of business, and so was not a 'private person'. It explained that the word 'any kind' itself expressly showed the broad meaning of business and even without the broad meaning of business the currency swaps were contracted in the course of Titan's business where it had to hedge the currency rate risk regularly. The court also pointed out that Titan entered into the currency swap, if partly, in expecting speculative profit and this speculative motive showed the swap deals were done in the course of business.

After the Titan case, some other non-individual consumers claimed their status as a 'private person' but all failed. While this negative result to consumers is not surprising because of the clear definition of a 'private person', it is helpful to take a look at some other cases. In *Camerata Property Inc v Credit Suisse Securities (Europe) Ltd*, the plaintiff was a paper investment company with a sole individual beneficiary.[435] The communication with the financial institution and the investment decision was done by the beneficiary who was an "individual person" but the contractor was the paper company and so excluded from 'private person'. Related with interest rate hedge products, some small and unsophisticated companies also claimed the status of 'private person' but were rejected

[433] [2010] EWHC 211
[434] Ibid [44]-[76]
[435] [2011] EWHC 479 (Comm)

because their legal entity was non-individual.[436] Based on the above cases, the Section 138D of FSMA 2000 is difficult to avoid the criticism that the definition of private person is too cursory because paper companies and small SMEs which are in reality as unsophisticated as individual persons are classified as non-private persons just by the types of legal entities.

4.4.3 Application of regulatory rules for private person

The above section shows who is entitled with the statutory "right of action" from breach of regulatory duties. This section will see how private law deals with alleged "mis-selling" of over-the-counter derivatives related with a private person that has the "right of action".

4.4.3.1 Meaning of a right of action

Even though the "right of action" itself does not automatically give rise to compensation,[437] a contravention, brought to the court by the statutory right of action, which caused a loss is likely to be led to a compensation order even without breach of common law duties. In *Morgan Stanley UK Group v Puglisi Cosentino*,[438] the court found the contravention of then regulatory rules including breach of suitability rule and risk warning rule and accepted that the breach had caused the consumer's loss. Though the court expressed that the consumer's claim for misrepresentation of the financial institution by common law was not successful,[439] it held for the consumer only based on the contravention of regulatory rules.

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[436] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133; *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc* [2013] EWHC 3167 (QB); *Thornbridge Limited v Barclays Bank Plc* [2015] EWHC 3430
[437] See n432
[438] [1998] C.L.C. 481
[439] Ibid p500

In two other cases, *Zaki & others v Credit Suisse (UK) Limited* [440] and *Basma Al Sulaiman v Credit Suisse Securities (Europe) Limited, Plurimi Capital LLP* [441], where the consumers as private persons claimed for compensation based on the statutory "right of action" contained in FSMA 2000, the court showed the will to make decisions based on regulatory rules without relying on private law.

4.4.3.2 The court's proactive approach

In applying regulatory rules to the case of a private person, the court has developed its own approach to the rules. *Zaki & others v Credit Suisse (UK) Limited* is a good example of the court's proactive approach in interpreting regulatory rules. In this case, the consumer bought 10 structured notes from Credit Suisse (UK) Limited ("CS") from 2007 to 2008. All of these notes were linked with performance of market indices or individual stocks, and if the linked stock market benchmark is above a "strike price" at the maturity of a note, the note can make an enhanced return to the holder, but if the benchmark has ever touched the barrier level (e.g. 55% of strike price), the note will be redeemed at the final level of the worst performing benchmark. After suffering a huge loss from these derivative-embedded products due to the global financial crisis in 2008, the claimant argued that CS breached the suitability rule of COBS during the process of the notes sales. There was no dispute about the status of the consumer as a "private person" because he was an individual person. The court judged whether or not there was breach of COBS and made its final ruling based on COBS and not on common law standards. The discussion below will highlight the court's proactive approach in interpreting and enforcing regulatory rules.

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[440] [2011] EWHC 2422 (COMM); [2012] EWCA Civ 583
[441] [2013] EWHC 400 (Comm)

The court's own approach to the suitability rule

CS's account manager failed to gather necessary information about the consumer for recommending suitable products. In the recorded form, investment objectives of the consumer were different from product to product sold and his net worth varied from £100 million to £250 million. The court acknowledged that CS lacked the rigor and care in obtaining information about the consumer and so breached the suitability rule of COBS.

In respect of suitability, COBS describes that 'A firm must take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client.',[442] and provided detailed rules of the 'reasonable steps'.[443] The suitability rule of COBS requires that financial institutions should recommend suitable products and for ensuring suitability they should follow the specified 'reasonable steps'. In other words, COBS requires certain procedures in order to make sure that suitable advice is recommended. So precisely speaking, whether or not a personal recommendation was suitable, it is a breach of COBS that a financial institution does not follow the reasonable steps stipulated in the COBS.[444]

However, the court stated that the regulatory failure in securing the client's information for suitable recommendation did not prove that the recommendation was not suitable. In its reasoning in the litigation, the court was focused on the suitability itself rather than the obedience of the procedural rules ensuring suitability. The court explained that:

> The important point, it seems to me, is whether the recommendations made by Mr. Zaki [salesperson] were suitable for Mr. Zeid [consumer]. If they were not suitable then it adds nothing to enquire whether Mr. Zaki's

[442] FCA Handbook, COBS 9.2.1R(1)
[443] Ibid 9.2
[444] See n324

> approach to obtaining and recording information and classifying the Claimants lacked the required rigour and care. If they were suitable, then again it cannot matter whether his approach to obtaining and recording information and classification was adequate or not... In that sense regulatory failures in the information gathering exercise may evidence a breach of the duty to take reasonable steps to ensure that the recommendations were suitable but they do not, it seems to me, assist in showing that the recommendations were not suitable.[445]

The court's focus on the substance rather than procedures in suitability was well revealed in its investigation on the consumer's risk appetite. The internal record of CS described the consumer's risk tolerance was "moderate", which was, as the compliance department of CS had stated internally, not compatible with the risk profile of the recommended products. However, the court put more weight on the consumer's prior investment experience in similar non-capital protected products and concluded that 'it does not follow that the 10 structured products which form the basis of this claim should be regarded as carrying a risk greater than that which Mr. Zeid [consumer] had been prepared to accept and which Mr. Zaki [salesperson] described in the suitability forms as "moderate"'.

The court's interpretation of suitability

Zaki & others v Credit Suisse (UK) Limited [446] also showed the court's proactivity in interpreting regulatory rules. The COBS subdivides suitability into three components: 'investment objectives', 'capability of bearing risk' and 'experience and knowledge' of the

[445] *Zaki & others v Credit Suisse (UK) Limited* [2011] EWHC 2422 (COMM) [99]
[446] Ibid

consumer.[447] In checking suitability of CS's recommendation, the court investigated not only those three components expressed in COBS but also investment diversity[448] and market conditions[449]. The court stated that the diversity in investments should be one of the elements when assessing the suitability of the recommendation, even though the COBS did not contain any explicit requirements about diversity. The court also took the turbulent market condition in 2008 into account for adjudication on suitability, even though the COBS did not require a financial institution to consider market conditions when recommending financial products.

The court adjudicated that the structured notes bought in 2008 were not suitable to the consumer, considering ominous market conditions where there were some harbingers of a dreadful global financial crisis such as the Northern Rock nationalization, acquisition of Bear Sterns, etc. The court stated that 'notwithstanding Mr.Zeid's [the consumer] appreciation of the risks and his ability to bear the consequences of them materializing, the line had been crossed in May/June 2008.'[450]

4.5 Causation

It is one of the tort law principles that in order to get compensated the claimant should prove that the wrongdoing of the defendant caused him the damage: 'no proof of causation, no compensation'.[451] In brief, causation in tort requires two types of causation: factual and legal causation.[452] Factual causation needs that the wrongdoing should be the necessary condition for the harm to the claimant to occur and requires to prove that

[447] FCA Handbook, COBS 9.2
[448] EWHC 2422 (COMM) [120]
[449] Ibid [126]
[450] Ibid [129]
[451] Sandy Steel, *Proof of Causation in Tort Law* (Cambridge University Press 2015) 1
[452] Kirsty Horsey and Erika Rackley (n 401) 224-255

without the wrongdoing the harm would not have occurred, so called the 'but for' test.[453] Legal causation means that the harm should be foreseeable at the time of the action.[454] Though the wrongdoing satisfies the 'but for' test, i.e. factual causation, if it is remote to the harm, causation is not proved.

This legal concept of causation is applied not only to the tort of "mis-selling" of the over-the-counter derivatives but also cases brought by the statutory "right of action" from regulatory breaches. Section 138D of FSMA 2000 provides a private person who suffers loss as a result of the contravention of the COBS with the "right of action" in damages. The phrase of 'as a result' is the requirement of causation and the above causation principles in tort is applied as well.[455]

4.5.1 Factual causation

In order to investigate factual causation, the court checks the consumer's reliance on the unsuitable advice (or misrepresentation) provided by the financial institution. The fact that the consumer relied on the unsuitable advice when making a decision of entering into an over-the-counter derivatives contract can prove that he would not have made the contract "but for" the advice.

In *Zaki & others v Credit Suisse (UK) Limited*[456] where the court found some unsuitable recommendation of derivatives-embedded notes as breach of the COBS, the court recognized that the consumer followed the salesperson's advice in some cases such as when he was first introduced to non-capital protected notes, but denied the reliance by

[453] Ibid p225
[454] Ibid p247
[455] *Adrian Rubenstein v HSBC Bank* [2012] EWCA Civ 1184 [45]; George Walker, Robert Purves and Michael Blair (n 116) para 7-30
[456] [2011] EWHC 2422 (COMM)

the consumer in some other purchases on advices, stating that he started making his own decisions in investments once he became familiar with non-capital protected notes. The court concluded that even if he had not been advised to buy the unsuitable notes, he would still have bought them and suffered loss because he made the investment decision based on his own view of the markets although unsuitable advice was given, and so there was no causal link between the unsuitable recommendation and the loss. The testimony of the salesperson that the consumer relied on his advice in making investment decisions was not sufficient evidence for the factual causation.

Then arises a subsequent question, under what circumstances is the factual causation between the breach and the loss able to be achieved? It is *Adrian Rubenstein v HSBC Bank* [457] that provides a clue to that question, where the factual causation between COBS breach and loss was accepted by the court (but it was not related with over-the-counter derivatives). In this case, the claimant, an individual person, asked HSBC for a safe investment without any risk of capital loss and the bank recommended a fund explaining that it was as safe as a bank deposit. His simple investment objective was putting temporarily his proceedings from his home sale in a safe account until the purchase of a new home. He double-checked with the bank whether the fund was safe and with a positive answer from the bank he invested in the fund in 2005. Even though the bank confirmed as such, the fund was not as safe as a bank deposit. The global financial crisis in 2008 caused the consumer a substantial loss. The trial court admitted that HSBC breached the COBS in that it recommended an unsuitable product and accepted the plaintiff's reliance on the bank's recommendation. The court explained that the consumer

[457] [2011] EWHC 2304

'was willing to invest his money in whatever Mr.Marsden [the salesperson] recommended'[458] and admitted that if the bank had not recommended as such, he would not have invested in the fund.

In summarizing the requirements of factual causation from above cases, entire reliance on advice, i.e. the attitude of following whatever advice, can pass the "but for" test whereas partial reliance, where the consumer with his own view makes an investment decision informed by the advice, cannot pass the test.

4.5.2 Legal causation

When unsuitable advice or misrepresentation is found to be a necessary condition of the consumer's loss (factual causation), the next step of proving causation is to determine if the unsuitable advice was remote to the loss (legal causation).

In *Adrian Rubenstein v HSBC Bank* above, the trial court investigated the legal causation after accepting the factual causation. It reasoned that the consumer's loss was not caused by the structure of the recommended investment product but by the evaporated market liquidity amid 2008 global financial crisis.[459] Based on this reasoning, the court concluded that the loss was not foreseeable at the time of recommendation, and so the legal causation was not accepted. However, this denial of legal causation was repealed at the court of appeal.[460] The appeal court explained that what the claimant tried to avoid was market risk but the bank recommended a product with market risk which was foreseeable, and so ruled that the bank's unsuitable recommendation caused the loss.

[458] Ibid [108]
[459] Ibid [113]-[115]
[460] *Adrian Rubenstein v HSBC Bank* [2012] EWCA Civ 1184

Two points can be picked up from the above decisions of the trial and appeal court on legal causation. Firstly, unless the consumer expresses that he wants to avoid market risk, the consumer may not be able to prove legal causation of the unsuitable advice to loss partly resulted from market turmoil, considering the fact that the court of appeal accepted the legal causation because of the consumer's expressed intolerance of market risk.

Secondly, these two cases with different results about legal causation show causal uncertainty due to 'multiplicity of possible causes'.[461] When there are two possible causes for a loss of a consumer, such as unsuitable advice and unexpected market movements, there is uncertainty in finding the "true" cause.[462] Uncertainty of how the courts will reason in causation test should be also pointed out. Unlike the above cases such as *Adrian Rubenstein v HSBC Bank* and *Zaki & others v Credit Suisse (UK) Limited* where the courts imposed tight criteria of proof of causation on the claimants, in *Morgan Stanley UK Group v Puglisi Cosentino,* for example, where the court ruled that the financial institution breached the suitability rule of then statutory regulation, it accepted the causality, without strict reasoning, just by explaining:

> It seems to me that the onus of proof of breach of statutory duty is on Mr Puglisi [consumer] and in relation to r. 730 he must also show that he relied on the advice given. In my judgment he did rely on that advice — indeed it would be absurd to suppose otherwise since without the recommendation of PERLS by Mr Revelli [sales person] he would never have entered the PERLS transactions or, indeed, heard of PERLS at all. I do not think he has to go further and show what he would have done if he had received the correct advice, but, if he had received proper advice, he would in fact not have invested in PERLS. [463]

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[461] Sandy Steel (n 451) 8
[462] Ibid
[463] [1998] C.L.C. 481, p499

Conclusion

This Chapter has explored how private law deal with disputes of "mis-selling" of over-the-counter derivatives. The first conclusion the Chapter has reached was that the court puts first priority on the contractual terms when imposing duties on parties of the transaction. When the reality of the transaction is different from what the contract describes, the court follows the right and duty defined by the contract. The decisions of the courts support the contract-first principle that the relationship defining clauses such as 'execution-only', 'no advisory service' and disclaimer clauses such as 'no representation', 'no reliance' and 'no liability' have full legal power regardless of the reality of the transactions.

The second conclusion is that the court has a stance that the regulatory rules can inform private law but cannot override it. For example, once advisory relationship is accepted in private law, the regulatory rules stipulating the duty of financial advisors can be embraced in private law standards but these rules cannot be referred to in the 'execution-only' relationship; the regulatory requirement of fair and clear communication on financial institutions is rejected in private law because the requirement is beyond the 'duty not to mis-state' of private law.

Thirdly, the court showed proactive approach in applying regulatory rules to civil cases brought by the "right of action" under the FSMA 2000. Strictly speaking, the "right of action" does not bind the court in its decision, but the court seems to be willing to make adjudication only based on the regulatory rules without considering private law principles. In interpreting regulatory rules, it also showed its capability and willingness to develop its own interpretation and standards related with regulatory rules. Even though some of the court's interpretations of the COBS such as adding "market condition" to factors considered for suitability is controversial, the court's proactive attempt to interpret regulatory rules is desirable for the progressive development of private law.

Lastly, this Chapter has considered the causation test in private law, which consists of factual and legal causation. The cases investigated showed that it is quite a high obstacle to prove causation from the side of consumers; for factual causation, the hypothetical assertion that he would have acted differently without the breach of the financial institution is difficult to prove in the court; for legal causation, as there are usually at least two causes for the loss such as breach of the financial institution and unexpected market turmoil, it is not easy for the consumer to single out the breach as the real cause for his loss.

Integrating all of these aspects and modalities of reasoning contained within private law shows that consumers are likely to have very little prospect of succeeding in obtaining compensation under private law. 18 cases[464] of "mis-selling" of over-the-counter derivatives verify the low prospect for consumers; only one consumer[465] out of 15 consumers (18 cases) succeeded in obtaining redress order in the court (See below Table 2). The first reason of this low "success" ratio on the side of consumers is that it is not probable for negligent advice or misrepresentation to be accepted in private law, considering the standard forms of over-the-counter derivatives contracts which include various 'exclusion clauses'.[466] Among 13 cases[467] where consumers alleged negligent

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[464] The 18 cases were chosen through Westlaw as following criteria: 1) cases including the words of "derivatives", "advice" and "duty of care" or "misrepresentation"; and 2) cases where consumers alleged "negligent advice" or "misrepresentation" or regulatory breach of financial institutions; and 3) cases adjudicated before 31st December 2015

[465] *Morgan Stanley UK Group v Puglisi Cosentino* [1998] C.L.C. 481

[466] Iain G Mitchell QC, 'Written evidence from Iain G Mitchell QC' (Parliamentary business, 2012) <http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27v_we17.htm> accessed 18 March 2016

[467] Cases which have "Y" or "N" in the column of "Applied by private law" in the Table 2 at 107

advice or misrepresentation in tort, there was no case where breach of private law standards was accepted.

The FSMA 2000 "right of action" for breach of regulatory duty gives better chance to consumers but this right is limited to only "private persons". Five corporate consumers[468] were denied the status of "private persons" and so had no statutory "right of action". Two consumers[469] out of three "private persons"[470] succeeded to obtain the court's ruling that there were statutory breaches by the financial institutions. Then, there is the last obstacle for consumers, which is the causation test. Only one consumer[471] out of two consumers who obtained the ruling of regulatory breach succeeded in proving causation and securing compensation order.

In Chapter III and IV, it has been discussed how financial regulation and private law approach to "mis-selling" of over-the-counter derivatives. As the next steop, the following Chapter will make analytical comparison of the two institutions in their approaches to the issue.

[468] Cases which have "N" in the column of "Private person" in the Table 2 at 107

[469] Cases which have "Y" in the column of "Breach of suitability" or "Breach of communication rule" in the Table 2 at 107

[470] Cases which have "Y" in the column of "Private person" in the Table 2 at 107

[471] The case which has "Y" in the column of "Causation" in the Table 2 at 107

Table 2: Summary of cases[472] related with "mis-selling" of over-the-counter derivatives between financial institutions and consumers

Cases (Name of consumer)	Adjudication Year	Applied by private law			Applied by regulatory rules (by the statutory "right of action")			Causation
		Existence of advice	Negligent advice	Misrepresentation	Private person	Breach of suitability	Breach of communication rule	
Dharmala[473]	1995	N 1)	N	N	-	-	-	N
Puglisi[474]	1998	-	-	N	Y	Y	Y	Y
Peekay[475]	2006	-	-	N	-	-	-	-
Springwell[476]	2008	N	N	N	-	-		N
Titan[477]	2010	N	N	-	N	-	-	-
Wachner[478]	2011	N	N	N	-	-	-	N
Ceylon[479]	2011	N	N	N	-	-	-	-
Zaki[480]	2011, 2012	-	-	-	Y	Y	-	N

[472] See n464
[473] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518
[474] *Morgan Stanley UK Group v Puglisi Cosentino* [1998] C.L.C. 481
[475] *Peekay Intermark Ltd and another v Australia and New Zealand Banking Group Ltd [2006]* EWCA 386
[476] *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186
[477] *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc* [2010] EWHC 211
[478] *Bank Leumi (UK) plc v Wachner* [2011] EWHC 656 (Comm)
[479] *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm)
[480] *Zaki & others v Credit Suisse (UK) Limited* [2011] EWHC 2422 (COMM); [2012] EWCA Civ 583

Cases (Name of consumer)	Adjudication Year	Applied by private law			Applied by regulatory rules (by the statutory "right of action")			Causation
		Existence of advice	Negligent advice	Misrepresentation	Private person	Breach of suitability	Breach of communication rule	
Camerata [481]	2011, 2012	Y	N	-	N	-	-	-
Grant[482]	2012	N	N	N	N	-	-	-
BAS[483]	2013	-	-	-	Y	N	N	N
Nextia[484]	2013	-	-	N	N	-	-	-
Green[485]	2012, 2013	N	N	N	-	-	-	N
Crestsign [486]	2014	N	Y 2)	N	-	-	-	-
Thornbridge[487]	2015	N	N	N	N	-	-	N

1) Court adjudication: Y (held), N (not held), - (not dicussed)

2) Negligent advice but not actionable due to the disclaimer of providing advice

[481] *Camerata Property Inc. v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm) 2011 WL 674989 (for 'Appplied by private law' in the Table 2); [2012] EWHC 7 (Comm) 2012 WL 14689 (for 'Applied by regulatory rules' in the Table 2)

[482] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133

[483] *Basma Al Sulaiman v Credit Suisse Securities (Europe) Limited, Plurimi Capital LLP* [2013] EWHC 400 (Comm)

[484] *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc* [2013] EWHC 3167 (QB)

[485] *John Green and Paul Rowley v The Royal Bank of Scotland Plc* [2012] EWHC 3661; [2013] EWCA Civ 1197

[486] *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc* [2014] EWHC 3043 (Ch)

[487] *Thornbridge Limited v Barclays Bank Plc* [2015] EWHC 3430

CHAPTER V. DISSONANCE BETWEEN PRIVATE LAW AND REGULATION

Introduction

There are two social institutions, private law and regulation, both of which "regulate" transactions of financial products including over-the-counter derivatives. The previous two Chapters have analysed how regulation and private law regulate over-the-counter derivatives transactions between financial institutions and consumers. The analysis of the previous Chapters provided a chance to understand the principles and rules of each social institution and at the same time provided clues of dissonance between them. The aim of this Chapter is to examine with the focus on the dissonance between private law and regulation in dealing with claims of "mis-selling" of over-the-counter derivatives.

The Chapter, firstly, will compare different duties put on financial institutions in the pre-contractual and contractual stages by the two institutions and identify the dissonance in more detail. This will be done by re-examining specific cases discussed in the previous two Chapters. It will then examine regulatory requirements through the lens of the fiduciary duty of private law. This will help to provide a better understanding of the nature of the dissonance between the two institutions. It will also examine the different approaches to causation test employed by each of the two institutions when determining whether compensation is due.

After developing a fuller understanding of the dissonance itself, the Chapter will consider its origins. It will look at the different functions which the two institutions are expected to undertake in society. This involves consideration of an economic analysis of law and regulation. Then, the Chapter will illustrate the trend whereby the two institutions are overlapping more and more, and try to explain why the two collide at times to produce some discordance of approach.

5.1 Dissonance between the two institutions

This section will try to find diverging principles and rules of private law and regulation in dealing with "mis-selling" of over-the-counter derivatives. This will need to compare duties put on the same activities of financial institutions in over-the-counter derivatives transactions by private law and regulation. It will be illustrated how differently the two institutions have dealt with the same activities and issues.

5.1.1 Different duties of the same activities

Of the activities in over-the-counter derivatives transactions, the most disputed two are: what product is recommended and how the recommendation is communicated. Private law and regulation have their own principles and rules in these activities. In terms of the product recommendation, first of all, criteria for defining an advisory relationship diverges between them. Secondly, in the activity of recommending a product, private law usually places a 'low level duty of care' on financial institutions, while regulation demands standards such as 'suitability' or 'appropriateness' which are judged against more demanding criteria. In regard to communication, principles of misrepresentation are applied in private law while 'fair, clear and not misleading communication' rule is applied in regulation. The below sections will compare the principles and rules of the two institutions on those two activities.

5.1.1.1 Duties on recommending a product

Both in private law and regulation, the question of whether the financial institution selling an over-the-counter derivative product has an advisory relationship with the consumer is critical to define its obligations in recommending a product. In private law, an advisor has more onerous obligations[488] than an execution-only service provider and in regulation an advisor is required to ensure "suitability" of the advice, which is not a duty demanded on an execution-only service provider. However, the ways in which the two institutions define advisory relationship are quite different. Before comparing duties in recommending, the difference in how the two institutions define advisory relationship needs to be looked at first.

Existence of advice

As seen Chapter IV, the court puts first priority on the contractual terms when deciding whether or not there is "advice".[489] Absence of contractual terms about providing advisory service can be the evidence of no advisory relationship and the disclaimer of providing advisory service leads to no advisory relationship regardless of the factual relationship.[490] In contrast, the regulation focuses on the actual relationship and communication between the financial institution and the consumer rather than contractual terms.

The precedent European Union financial regulator, Committee of European Securities Regulators[491] ("CESR") provided the criteria for deciding the existence of an advisory service based on the actual relationship.[492] This criteria is a practical convergence tool used to promote common supervisory approaches in member states and, therefore competent

[488] See n374
[489] See n375
[490] See n376-n383
[491] The CESR is the predecessor of the current European Union financial regulatory institution, the European Securities and Markets Authority (ESMA), which has replaced the CESR in 2011
[492] Committee of European Securities Regulators, 'Questions and Answers: Understanding the definition of advice under MiFID' (2010, Ref. CESR/10-293). This Q&A is a practical convergence tool used to promote common supervisory approaches and practices under Article 29(2) of the ESMA Regulation, therefore competent authorities in member states are to follow this Q&A.

authorities in member states are to follow this.[493] A close look at this criteria helps to understand the regulatory approach on this issue. The CESR suggested 'the five key tests for investment advice' to determine whether services of a financial institution constitute investment advice.[494] All the five key tests should be met for a service offered to be recognized as advice. The first test among the five key tests is whether the service offered constitutes a recommendation.[495] A recommendation is a course of action such as buying, selling and holding a financial instrument whereas giving information is statements of fact or figures.[496] Therefore, simply giving information without suggesting a specific action of the client is not advice.[497]

The second test is whether the recommendation is in relation to one or more transactions in financial instruments.[498] Investment advice should relate to a particular financial instrument, so generic advice about a type of financial instrument such as investment in a geographical zone or a manufacturing industry in a stock market does not constitute investment advice.[499] A general recommendation which is a recommendation intended for distribution channel or the public is also not investment advice.[500]

The third test has two questions. When only one is met, the third test is qualified. One of the two questions is 'whether the recommendation is presented as suitable'.[501] A recommendation stating a financial instrument as suitable explicitly or implicitly for the

[493] Regulation (EU) No 1095/2010, article 29(2); see European Securities and Markets Authority, 'MiFID Questions and Answers: Investor Protection and Intermediaries' (ESMA/2012/382, 2012) para 3
[494] Ibid p6
[495] Ibid p7
[496] Ibid
[497] Ibid
[498] Ibid p9
[499] Ibid p10
[500] Ibid
[501] Ibid p11

investor constitutes advice. It should be noted that an implicit statement like 'people like you tend to buy this product' as well as an explicit promotion like 'this product is the best option for you' are all seen as advice.[502] The CESR also describes that even a clear disclaimer by a financial institution stating that no advice is being given cannot change the nature of the communication as investment advice.[503] The other question in the third test is whether 'the recommendation is based on a consideration of a person's circumstances'[504]. Circumstances here means the information about the client's financial status, long-term and short-term financial objectives and risk appetite, for example.[505] Whether or not a financial institution considers its client's circumstances when recommending, the client's perception is the decisive point here.[506] This means that a financial institution is held responsible if it gives the impression that its product recommendation is based on the client's circumstances. In summary, the third test is met if the recommendation is presented as being suitable to the client or is promoted with the impression that it is given on the basis of the client's financial circumstances.

The fourth test is whether 'the recommendation is issued otherwise than exclusively through distributional channels or to the public'.[507] The relevant consultation paper specifies newspaper, radio and TV as distributional channels or medium to the public in general.[508] The point here is whether the client given the recommendation is a particular person or group or unknown people. Investment advice should be a personal

502 Ibid
503 Ibid p12
504 Ibid
505 Committee of European Securities Regulators, 'Understanding the definition of advice under MiFID' (Consultation Paper, 2009, Ref. CESR/09-665) 11
506 Committee of European Securities Regulators, 'Questions and Answers: Understanding the definition of advice under MiFID' (n 492) 12
507 Ibid p13
508 Committee of European Securities Regulators (n 505) 12

recommendation targeted to a particular person or group. The fifth test is whether 'the recommendation is made to a person in his capacity as a (potential) investor or as an agent of a (potential) investor'.[509] This test means that a recommendation given to a person without any capacity of (potential) investor does not constitute investment advice.

The above criteria expressly states that advisory relationship is decided by the actual communication between financial institutions and consumers, not by contractual terms. This approach was confirmed by the FSA which said that terms excluding advice from the remit of services provided continued to be possible but they could not operate to exclude the application of the FSA rules where investment advice was actually given.[510] This response clarifies that the FSA looks at the content of communication when deciding the existence of advice.

By way of example of application of the above tests, *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc*,[511] clearly reveals the diverging criteria between private law and regulation in determining the existence of advisory relationship. In this case, the court rejected the existence of advice based on contractual terms expressing that no advisory service had been provided.[512] The following discussion will examine the existence of advice based on the regulatory perspective by applying above criteria of CESR to the case.

The Bank's corporate treasury manager sent the Titan financial controller an e-mail, which said as follows:

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[509] Committee of European Securities Regulators, 'Questions and Answers: Understanding the definition of advice under MiFID' (n 492) p15

[510] Field Fisher Waterhouse, 'A Guide to the New Conduct of Business Sourcebook and new Systems and Controls rules' (2007) 49 <http://www.fieldfisher.com/pdf/NEWCOB-and-SYSC.pdf> accessed 21 July 2016

[511] See n370; [2010] EWHC 211

[512] See n384

> The idea below gives you the opportunity to outperform the spot and forward rates for your expected EUR requirement. Importantly, it is not a hedge. However, this additional trade does give you the opportunity to achieve rates better than what is available in the market by conventional spot or forward contracts. The numbers below are based on a minimum of €0.5m per month and a maximum of €1m per month. The basis for the trade is to provide an enhancement to your existing hedge and to run in conjunction with it.[513]

1. *Test 1: Does the service offered constitute recommendation?* In this e-mail, sentences like 'The idea below gives you the opportunity to outperform the spot and forward rates for your expected EUR requirement.' and 'The basis for the trade is to provide an enhancement to your existing hedge and to run in conjunction with it.' are recommendations to buy the product whether it was explicit or implicit.

2. *Test 2: Is the recommendation in relation to one or more transactions in financial instruments?* She explained the specific condition and terms of the September product such as "a minimum of €0.5m per month and a maximum of €1m per month". This shows her recommendation was related with a particular transaction of a financial instrument.

3. *Test 3: Is the recommendation as least one of a) presented as suitable or b) based on a consideration of the person's circumstances?* She pointed out that 'The basis for the trade is to provide an enhancement to your existing hedge and to run in conjunction with it.' This statement expressed that the new product was "suitable" to Titan's 'existing hedge' products. She also said that 'The idea below gives you the opportunity to outperform the spot and forward rates for your expected EUR requirement.' This shows that her recommendation was based on her knowledge on Titan's 'expected EUR requirement', the

[513] *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc* [2010] EWHC 211 [42]

client's circumstances. In addition, Titan had had a business relationship with the Bank for ten years already at that time. From the view of business practice, it can be expected that a bank with a business relationship of 10 years with a consumer[514] would suggest a financial product based on good knowledge and consideration of its client's financial circumstances and objectives.[515]

4. *Test 4: Is the recommendation issued otherwise than exclusively through distribution channels or to the public?* This e-mail was sent to the Titan's financial controller's personal e-mail account, so the recommendations meets this test.

5. *Test 5: Is the recommendation made to a person in his capacity as one of an (potential) investor or an agent for an (potential) investor?* She recommended the product to the Titan's financial controller who is an agent of an investor.

The result of the application of these tests is that the Bank's recommendation of the over-the-counter derivative to Titan was "advice" from the regulatory perspectives. This is a contrary result to the court's adjudication that there was no advisory relationship.[516] In essence, private law recognizes contract-based advisory relationship while regulation seeks 'de-facto' reality-based advisory relationship.

Duties in transacting a product

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[514] Titan started currency transactions with the Bank since 1997.

[515] Committee of European Securities Regulators, 'Questions and Answers: Understanding the definition of advice under MiFID' (n 492) 13, where "If a firm has accumulated relevant information on a person's circumstances-either during a single interview or during the course of an ongoing relationship-and it can reasonably be expected that this information is being taken into account. In this case, any recommendation made will be treated as being based on a consideration of the person's circumstances. This situation is perhaps most likely to arise if a firm collects potentially relevant information from a client through one contact point, as part of an established relationship. In this situation, the firm could be held responsible for giving the impression that it is basing its later recommendations on information about the person's circumstances collected earlier."

[516] See n370

The above part has compared different criteria in determining whether there is advisory relationship. This part will take a look at the different duties of financial institutions when transacting over-the-counter derivatives with consumers. Private law puts as heavy duties on a financial advisor as regulation does.[517] But as standard contract forms disclaim advisory service, it is rare for a financial institution to have the status of advisor in over-the-counter derivatives transactions as seen Chapter IV.[518] When there is no advisory relationship, private law acknowledges a 'low level duty of care' of financial institutions in transactions of over-the-counter derivatives with consumers.[519] Considering the effect of contractual terms disclaiming advisory service, a 'low level duty of care' is the "usual" requirement in private law. This duty includes 'not to make a negligent misstatement' and 'to use reasonable care not to recommend a highly risky investment' without warning about the risks.[520]

On the other hand, regulation requires 'suitability'[521] within provision of advisory service and 'appropriateness'[522] during an execution-only service. Under the suitability rule of the COBS, an investment advice should 1)meet the client's investment objectives, 2) be such that the client is able to financially bear the investment risk, and 3) be such that the client has the necessary experience and knowledge in order to understand the investment risk.[523] The suitability rule demands the financial institution to 'know your clients' first and then to provide proper advice in line with its knowledge of the client, and this rule is absolutely beyond the 'low level duty of care' in private law. Even with the execution-only service,

[517] See n374
[518] See table1
[519] See n392
[520] See n392
[521] FCA Handbook, COBS Chapter 9
[522] FCA Handbook, COBS Chapter 10
[523] FCA Handbook, COBS 9.2.2R

regulation requires financial institutions to assess 'appropriateness' of the transaction requested by consumers, by assessing whether the consumer has necessary experience and knowledge to understand the risks associated with the transactions.[524] Assessing the consumer's experience and knowledge against the risks of the financial product is also out with the obligation 'not to make a negligent misstatement' or 'or 'to use reasonable care not to recommend a highly risky investment without warning about the risks'.

In *Titan v The Royal Bank of Scotland*,[525] the court ruled that there was no breach of a duty of care by the Bank. The next part of the discussion will assess the "suitability" of the one of the over-the-counter derivatives recommended to Titan. Titan was classified as a "professional client" under the COBS. Under the COBS, for a professional client, only the objectives of the transaction should be assessed for suitability because the professional client's capability of bearing the risk from the transaction and sufficient experience and knowledge about the transaction can be assumed.[526] The objectives of Titan to enter into the currency swap was to hedge the euro/sterling currency rate risk when it had to sell euros earned through sales in continental Europe to buy sterling for the expenses in the UK.[527] During the telephone conversation in June 2007, Titan's financial controller made it clear to the Bank's corporate treasury manager that its objective of currency derivatives deals was hedge, by saying 'And, and the one thing I've done is to actually protect it, if it screws, and I think that's the main thing really… I know I'm not going to make a load of money, but I'm trying to save us from losing a lot of money. I don't know if you see what I mean.'[528] The June currency swaps provided Titan with protection from the weakness of

[524] FCA Handbook, COBS 10.2.1R
[525] See n370; *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc* [2010] EWHC 211
[526] FCA Handbook, COBS 9.2.8R.
[527] Ibid [71]
[528] Ibid [41]

euro above the "upper level" currency rate. Even though the amount (€2.0 million per month) it should sell when the euro strengthened below "lower level" was twice to the amount (€4.0 million per month) it was protected above the "upper level", this condition was to provide Titan with better terms for protection. Therefore, the structure of the June currency swap was suitable to Titan's financial objectives, which was to hedge. The volume of the deal was also not beyond the hedge objective. The amount it should sell was €2~4 million per month, annually €24~48 million, which was reasonable from the perspective of hedging, considering Titan's annual turnover, €36.5 million.[529] It means that even when the currency rate moved adversely to Titan in the currency swap (i.e. strengthened euro), the euros that Titan earned from its business could offset most of the losses from this currency swap. This was a hedge.

The September currency swap contained more speculative structures compared with the June product. It would cause loss to Titan when the spot currency rate went down below the "upper level" (called "accrual rate" in the September product), whereas the June product would cause loss to Titan only when the spot rate went down below the "lower level" which was set quite lower than the accrual rate. Additionally, even when the spot rate went up above the "upper level", the profit of Titan was limited by 10 cents per euro. In essence, the September product was a betting on expectation about the narrow movement range of the euro/sterling currency rate. In spite of this speculative product structure, any possible loss from this product could be offset by the strengthened euro that Titan had, but only if Titan had enough euro cash flow. However, Titan already held an exposure of 24~48 million euros in the June product and its annual euro earning was €36 million, so

[529] See eg International Accounting Standard 39 requires that hedge must offset changes in fair value or cash flows attributable to the hedged item within a boundary of 80~125%.

additional exposure to currency swaps on top of the June product would mean an over-hedge.[530] The Bank's account manager should have given attention to this over-hedge because the consumer's objective was to hedge.[531] Titan's financial controller also stated to the Bank's manager that he was 'clearly concerned at the scale of the product' during the telephone conversation before entering into the September product.[532] This comment shows that he was concerned about the over-hedge created by the September product. Considering the speculative feature and over-hedge[533], under regulation, the September currency swap can be seen unsuitable to Titan whereas the June product seems to be suitable.

In summary, in the case of *Titan Steel Wheels Ltd v The Royal Bank of Scotland*, private law did not accept advisory relationship nor breach of a duty of care of the financial institution, whereas under regulation the financial institution provided advisory service and breached the "suitability" rule.

5.1.1.2 Duties in communication

In terms of communication in the process of over-the-counter derivatives transactions, private law and regulation have different standards as well: misrepresentation in private

[530] *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc* [2010] EWHC 211 [42]; Titan should sell 0.5~1 million euros per month, annual 6~12 million euros.

[531] European Securities and Markets Authority, 'Final Report Guidelines on certain aspects of the MiFID suitability requirements' (2012) 32, where it stated 'Similarly, where the investment service consists of the provision of investment advice or portfolio management to a 'per se professional client' the firm is entitled to assume that the client is able to financially bear any related investment risks consistent with the investment objectives of that client and therefore is not generally required to obtain information on the financial situation of the client. *Such information should be obtained, however, where the client's investment objectives demand it*.[*Emphasis added*]'

[532] Ibid [43]

[533] see n320, where the regulator required over-hedging interest rate hedge products to be compensated

law and 'fair, clear and not misleading communication' rule[534] in regulation. The below part will compare the two different duties.

Private law does not see "opinions" as misrepresentations.[535] In *JP Morgan Chase Bank v Springwell Navigation*, the claim that the bank misrepresented the state of the Russian economy as being strong when it was just before the country's moratorium was rejected by the court because the comment on the Russian economy was just an "opinion" and could not constitute misrepresentation.[536] On the contrary, too rosy or unbalanced predictions on the market, which were kind of "opinions" of the financial institutions, have been penalized by the regulator. For instance, Chase de Vere Financial Solutions was sanctioned because the regulator decided that the promotional materials on its FTSE 100-connected derivative products asserting that FTSE 100 would perform well without proper risk warnings were breach of 'fair, clear and not misleading communication' rule.[537] Santander was also penalized due to its rosy opinions on the equity market related with its derivatives-embedded investment product.[538]

Factually wrong explanations are also rarely seen as a misrepresentation in private law. This is, firstly, because of contractual estoppel from the clauses disclaiming of representation such as "no representation" and "no reliance on representation".[539] In *Peekay Intermark v Australia & New Zealand Banking Group*, even though the bank explained factually wrong characteristics of the investment product, the contract stating that the consumer 'fully understands the nature of the transaction' estopped him from

[534] FCA Handbook, COBS 4.2.1R
[535] See n395
[536] See n403
[537] See n302
[538] See n307
[539] See n408

asserting misrepresentation.[540] Secondly, misrepresentation which actually doesn't induce the claimant to enter into the contract is not actionable.[541] In recent litigation related to interest rate hedge products, a financial institution's failure of full explanation about "break cost" was not accepted as a misrepresentation in that the court believed that even detailed explanation about the break cost would not have changed the consumer's decision of entering into the over-the-counter derivative contract.[542]

On the contrary, regulation has much stricter rules on representation. It does not acknowledge the effect of disclaimers in contracts. The COBS prescribes that financial institutions must not 'exclude or restrict' or 'rely on any exclusion or restriction of' any duty or liability it may have to a consumer under the regulatory system.[543] Therefore, disclaimers excluding liabilities of misrepresentation cannot prevent the regulator from sanctioning misleading communications. Secondly, the breach of 'fair, clear and not misleading communication' rule does not depend on whether the consumer is actually induced by the communication. Even though this communication rule demands communication not to mislead but the actual consequence of consumers being misled is not a necessary factor for sanction. For instance, where a financial institution wrongly explained that the investment principal of a fund was protected by the Financial Services Compensation Scheme, the regulator sanctioned the financial institution without evidence that consumers were actually induced to buy the product with that false communication.[544]

[540] See n409
[541] See n410, n411
[542] See n412
[543] FCA Handbook, COBS 2.1.2R
[544] Financial Supervisory Authority, 'FINAL NOTICE to SANTANDER UK PLC' (2012)

Thirdly, the 'fair, clear and not misleading communication' rule requires not only to provide non-false facts but to provide "suitable" information in a "suitable" way for the consumer.[545] This means that the financial institution should consider what information and what communication method is suitable for the consumer.[546] The sanction case of Credit Suisse International is a good example. This financial institution promoted that its investment product could gain a maximum 50% return, which was theoretically possible and so factually not false, but was penalized by the regulator which decided that the highlighting of a maximum return, which had a very low probability to be realized, was a misleading communication.[547]

There is another difference in obligations in checking consumers' understanding of explanations given by financial institutions. Private law does not impose an obligation on the financial institution to ensure that the consumer understands its explanation.[548] In *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc*, the court ruled that the financial institution which transacted a 10 year-maturity interest rate swap for a 5 year-maturity loan with a brief factual explanation did not have a duty to 'take adequate steps to ensure the consumer had an adequate understanding of the full range'.[549] On the contrary, regulation expressly states that financial institutions should 'take reasonable steps' to ensure that their communication is 'fair, clear and not misleading'.[550] In terms of interest rate hedge products with the longer maturity than the one of the hedged loan, the regulator expressed that financial institutions must 'determine

[545] FCA Handbook, COBS 4.2.2G(1)
[546] Alastair Hudson, *The Law of Finance* (n90) para 10-19
[547] See n310
[548] [2014] EWHC 3043 (Ch); See n415
[549] Ibid
[550] FCA Handbook, COBS 4.2.6R

whether it is reasonable to conclude that the customer could have understood the features and risks of the product' and if otherwise, it was non-compliance of regulation.[551]

Another difference between misrepresentation in private law and 'fair, clear and not misleading communication' rule in regulation is the stance towards omission of explanation. In private law, 'caveat emptor' is the basic and informing principle and omission of explanation, in general, does not constitute misrepresentation.[552] For example, in *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc*, the failure to explain about negative mark-to-market value in an interest rate swap was not ruled as a misrepresentation in private law.[553] On the contrary, the regulator required compensation on the loss from an interest rate swap, where the information about its negative mark-to-market value was not explained to the consumers.[554]

In summary of the above analysis of duties of financial institutions in communication, private law imposes the level of obligations of merely not to state false facts, while regulation demands financial institutions to try to ensure that consumers understand every material features and risks of the transacted product.

5.1.2 Conduct of business rule v fiduciary duty

The previous section has shown the different requirements of private law and regulation on financial institutions in transactions of over-the-counter derivatives. It was found that obligations on financial institutions in regulation are much more demanding and onerous than ones in private law. While private law puts obligations as a counterparty of an "arm's

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[551] Financial Services Authority, 'Interest Rate Hedging Products Pilot Findings' (2013) 12-13
[552] See n398
[553] [2013] EWHC 3167; see n418
[554] See n314

length" contract on financial institutions, the regulation demands high level care and loyalty to consumers which has similarity to fiduciary duties in private law. The sections below will take a look at the concept of fiduciary duties in private law and then compare it with the conduct of business rule in regulation. This analysis will help to understand the dissonance of requirements of private law and regulation.

5.1.2.1 Fiduciary duty in private law

Private law defines a fiduciary as 'someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence'.[555] The fiduciary relationship is characterized with 'discretion, power to act and vulnerability'.[556] Fiduciary duties are crafted in private law to protect vulnerable principals who the fiduciary has power to act for.[557] The core of fiduciary duties is loyalty to the principal.[558] In detail, the 'loyalty' duty requires the fiduciary to 'act in good faith'; 'not to profit out of the trust'; 'not to place himself in a position where his duty and his interest may conflict'; 'not to act for his benefit or the benefit of a third party without consent of the principal'.[559] In private law, there are two types of fiduciaries; the first category is the one already recognized as fiduciary by their nature of the relationship such as trustee and beneficiary; agent and principal; director and company.[560] The other one is open and fact-based, which means that the fiduciary relationship is decided based on the facts and circumstances of the relationship.[561] Even though a financial advisor is not an

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[555] *Bristol & West Building Society v Mothew* [1998] Ch 1, 18
[556] Law Commission, *Fiduciary Duties and Regulatory Rules* (*Consultation Paper* 124, 1992) para 2.4.6
[557] Law Commission, *Fiduciary Duties of Investment Intermediaries* (Consultation Paper 215, 2014) para 4.12
[558] John Kay, 'The Kay review of UK equity markets and long-term decision making. Final Report' (2012) para 9.6
[559] *Bristol & West Building Society v Mothew* [1998] Ch 1, 18
[560] Law Commission, *Fiduciary Duties of Investment Intermediaries* (Law Com No 350, 2014) para3.14
[561] Ibid para 3.14-3.16

already recognized fiduciary like a trustee, agent or director,[562] it is 'commonplace for the courts to find that the advisor has placed himself under fiduciary obligations'.[563] For instance, in *JP Morgan Chase Bank v Springwell* the court acknowledged widely ranging duties of an advisor.[564]

In private law, the fiduciary duty arises only when one person agrees to act for or on behalf of another person,[565] and the extent of the duties can be modified by the agreement between the fiduciary and the principal.[566] Therefore, financial institutions tend to try to avoid or limit the onerous fiduciary duties through contractual terms of standard forms, which are generally accepted by the courts unless there is any dishonesty by the fiduciary.[567] As a result, it is rare to see financial institutions assume a fiduciary obligation or duties as an advisor in the transactions of over-the-counter derivatives.[568]

5.1.2.2 Conduct of business rule as fiduciary duty

The discussion above has considered the concept of fiduciary duties in private law and explained why it is difficult to see those duties arise in over-the-counter derivatives transactions. The below part is a comparison of the COBS in regulation with fiduciary duties in private law. Actually one of fundamental concepts of COBS came from fiduciary duties in private law. The conduct of business rule of MiFID, from which the COBS was

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562 Alastair Hudson, *THE LAW OF FINANCE* (n 90) 5-10

563 *Investors Compensation Scheme v West Bromwich Building Society* [1999] Lloyds Rep.PN496, 509; McMeel, Gerard, and John Virgo (n 399) para 8.10

564 *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186 [616]

565 *White v Jones* [1995] 2 A.C. 207 at 271; McMeel, Gerard, and John Virgo (n 399) para 8.08; James J Edelman, 'When do fiduciary duties arise?' (2010) *Law Quarterly Review* 126, 302, n35

566 Alastair Hudson, *THE LAW OF FINANCE* (n90) 5-04; Simon James (n 103) para 5.4; James J Edelman (n 565) 315

567 Alastair Hudson, *THE LAW OF FINANCE* (n90) location 7005 (kindle edition)

568 See Table2 at 107; Simon James (n 103) para 5.4; Frank Partnoy, 'ISDA, NASD, CFMA, and SDNY: the four horsemen of derivatives regulation?' (2002) 2002.1 Brookings-Wharton Papers on Financial Services 213, 221

'intelligently copied',[569] was announced that it adopted fiduciary duties for enhancing investor protection.[570]

In detail, the COBS demands that financial institutions act in 'the best interests of its client'.[571] This is the highest level requirement of integrity expected of financial institutions, which is equivalent to 'good faith' of fiduciary duties.[572] The 'fair, clear and not misleading communication' rule is also interpreted as one of fiduciary duties.[573] This rule requires the financial institutions, on behalf of the consumer, to choose the proper information and the proper way to deliver it in order not to mislead the consumer. The obligation of disclosure of all necessary facts for the consumer's informed decision, which this rule requires, is also seen as one of fiduciary duties.[574]

The COBS demands that financial institutions provide consumers with the information on fees charged[575] and prohibits financial institutions from receiving any fee or non-monetary benefits from third parties related with services carried on for the consumer[576]. These rules related with fees are similar to 'not to profit out of the trust' and 'not to act for his benefit or the benefit of a third party without consent of the principal' of fiduciary duties.[577] The suitability rule requires financial institutions first to understand investment objectives and circumstances of the consumer and then provide advice which fits with the consumer. This

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[569] Financial Services Authority, 'Reforming Conduct of Business Regulation' (2006) para 2.11
[570] European Commission, 'BACKGROUND NOTE. Draft Commission Directive implementing the Markets in Financial Instruments Directive 2004/39/EC' (2004) para 7.1
[571] FCA Handbook, COBS 2.1.1(1)R
[572] Alastair Hudson, 'The synthesis of public and private in finance law' in Barker, Kit, and Darryn Jensen (eds), *Private law: key encounters with public law* (Cambridge University Press 2013) n79; Alastair Hudson, THE LAW OF FINANCE (n 90) para 10.17
[573] Alastair Hudson, *THE LAW OF FINANCE* (n 90) para 10.19-10.20
[574] McMeel, Gerard, and John Virgo (n 399) para 8.09
[575] FCA Handbook, COBS 6.1.9R
[576] FCA Handbook, COBS 2.3.1R
[577] McMeel, Gerard, and John Virgo (n 399) para 8.17

rule is not inconsistent[578] with the concept of fiduciary duties in that it puts a much higher obligation on financial institutions than ‘caveat emptor’ in private law, which allows them to leave it to consumers to evaluate the characteristics and risks of financial products.[579] In addition, the financial institution should stop providing advisory services to the client if it cannot assess the suitability due to insufficient information about the consumer.[580] This requires the financial institution to place the interests of consumers first to its own profit, which is also similar to fiduciary duties.

While the COBS shares common characteristics with fiduciary duties of private law, there are some critical differences. The previous section already explained that fiduciary duties in private law arise only when a person undertakes the role of a fiduciary and the extent of the duties can be modified by contracts.[581] However, the obligations of the COBS take effect without the explicit undertaking of those duties and they cannot be modified or limited by contractual terms. The COBS expressly stipulates that financial institutions should not seek to exclude or rely on any exclusion of obligations under the regulatory system,[582] and the regulator, for instance, announced that the disclaimer of advisory service had no effect on its regulatory actions.[583] The COBS does not accept any relaxation of obligations on financial institutions or reallocation of right and duties based on what the contract may represent as being “agreed” between financial institutions and consumers.

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578 Cheryl Goss Weiss, ‘Review of the Historic Foundations of Brokre-Dealer Liability for Breach of Fiduciary Duty’ (1997) *J. Corp. L.* 23, 65, 99
579 Alaistar Hudson, *THE LAW OF FINANCE* (n 90) para 3.11
580 FCA Handbook, COBS 9.2.6R
581 See n565, n566
582 FCA Handbook, COBS 2.1.2R
583 See n510

Then, what has led the fiduciary duties which already existed in private law to be written in regulation? Johannes Köndgen suggested two answers: the first is that moving duties of contractual origins to public law obligations can 'ensure that rules of conduct become immune against any attempt to contract them out'; the second answer is that the legislator was suspicious of consumers' capability to recognize breach of duties by financial institutions and to take private law actions, even after recognizing the breach, due to burden of proof or financial risk in their litigation.[584]

5.1.3 Different approach to causation

Above section 5.1.1 examined the different duties imposed by private law and regulation on transactions of over-the-counter derivatives. When any breach of duties is found, the next stage in both institutions is compensating the damages caused by the breach. A compensation order, whether by the court or the regulator, needs assessment of causation between the breach of duties by financial institutions and the loss of consumers, which is the reasoning of whether the breach has indeed caused the loss. This section will compare the approaches taken by private law and regulation to causation in cases of the alleged "mis-selling" of over-the-counter derivatives.

5.1.3.1 "Precise" causation of private law

A causation test in private law is the process of 'allocating responsibilities for harm'.[585] Every case in tort law has a sharp bipolar relationship between litigating parties, where a compensation for the claimant means a liability for the defendant and so tort law is focused

[584] Johannes Köndgen, 'Rules of conduct: Further harmonisation' in Guido Ferrarini, *European securities markets: The investment services directive and beyond* (Kluwer Law International 1998) 117

[585] P Laleng, 'Causal Responsibility for Uncertainty and Risk in Toxic Torts' (2010) 18 Tort L Rev 102, 103

on ‘corrective justice’.[586] Therefore, private law tries to find the “precise” answer to the question, “Did the financial institution’s breach actually cause the loss of the consumer?”[587] It endeavours to find what exactly happened “due to” the breach. In order to reach the “precise” causation result, a “factual causation” test and a “legal causation” test are applied to the case.[588]

Rubenstein v HSBC Bank shows the focus of the court on finding a “precise” causation. The trial court reasoned, after accepting that the financial institution’s recommendation of a fund with a limited risk of loss to the consumer who wanted a product without any risk of principal loss was unsuitable, that “but for” the unsuitable advice the consumer would not have invested in the fund.[589] To reach this conclusion about the factual causation, the trial court dived deep into a pile of communication records including telephone conversations and e-mails between the two parties before the transaction.[590] Through this thorough examination of communication records, the court was convinced of the consumer’s reliance on the representative of the financial institution and accepted the “factual causation”. Then for the legal causation test, the court heard witnesses of experts about relationship between the loss of the fund and the characteristics of the fund and the global financial crisis.[591] Based on these witnesses and its own analysis of the financial market during the crisis, the court denied the “legal causation” in that the loss from the

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[586] Donal Nolan, ‘Causation and the goals of tort law’ in Robertson, Andrew, and Hang Wu Tang (eds), *The goals of private law* (Bloomsbury Publishing 2009) n3
[587] Stephen D Sugarman, ‘Precise Justice and Rough Justice: Scientific Causation is Civil Litigation as Compared with Administrative Compensation Plans and Mass Torts Settlements’ (2004) 137 < http://works.bepress.com/stephen_sugarman/45> accessed at 1st April 2016
[588] See n452
[589] See n456
[590] *Adrian Rubenstein v HSBC Bank* [2011] EWHC 2304 [14]-[38]
[591] Ibid [109]

recommended fund was due to the financial crisis in 2008 and was not foreseeable at the time of giving advice.[592]

However, the appeal court suggested a different opinion as to the causation in this case, stating that:

> It is said that a section 150 claim [the predecessor of section 138D of FSMA 2000, which entitles a statutory right of action for regulatory breach] is subject to identical principles relating to causation, foreseeability and/or remoteness of damage as may apply in contract or tort, and the judge generally made no distinction between any of Mr.Rubenstein's three causes of action for these purposes, or for the purposes of his finding of negligence. However, whereas the underlying principles may be the same, they may operate in different ways, seeing that the purpose of a statutory rule may be more focussed than the general law of tort or contract is likely to be.[593]

This suggestion that causation test, especially related with breach of regulation, should consider the purpose of regulation is quite a new perspective in private law but paradoxically shows the fact that the courts have adhered to "precise" causation. Actually, albeit this new suggestion about causation, the appeal court held "legal causation" in a very "precise" way: the loss was not remote because the financial institution recommended a product with "market risk" which the consumer tried to avoid indeed and so the loss was foreseeable.[594]

The court can be convinced of causality only when both factual and legal causation requirements are satisfied. If the claimant cannot prove the causation factually and legally, the court has to assume that the breach did not cause the loss. For the court, it is not permissible as much to hold that the defendant is liable for the losses which he did not

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[592] See n459

[593] *Adrian Rubenstein v HSBC Bank* [2012] EWCA Civ 1184 [45]

[594] See n460

cause indeed.[595] "Precise" causation thus does not accept the causality unless the claimant proves that he would have acted differently without the breach. In *Green & Rowley v Royal Bank of Scotland plc*, the consumer entered into a 10 year-maturity interest rate swap with the bank to hedge interest rate risk of his 5 year-maturity loan.[596] The consumer was shocked with the break cost being almost 30% of his hedged loan when he tried to exit the swap 4 years after entering into the contract.[597] The court said that 'Had they been told that the cost could be substantial…, it is far from clear that they would have stopped there…'[598] Unless the court is persuaded that the claimant evidently would have acted differently in the absence of any breach, the causation is not complete.

5.1.3.2 "Fair" causation of regulation

FSMA 2000 enables the regulator to use a 'power to require restitution'[599] or establish 'consumer redress scheme'[600] with the condition that the loss of consumers is a "result" of the contravention of financial institutions. Therefore, the regulator should assess the causation as well when it pursues redress for consumers.

While the court pursues "precise" causation, the regulator can be said to pursue "fair" causation. This does not mean that the regulator's approach to causation is more "fair" than the court's one but that the regulator seeks to find a "fair" result from the perspective of its core objectives in investigating causation. In the case of interest rate hedge products, the regulator reasoned that if there was no breach by financial institutions in the transactions of the products, the "average" consumer would have selected a simpler IRHP

[595] Stephen D Sugarman (n 587) 138
[596] [2012] EWHC 3661
[597] See n412
[598] *Green & Rowley v Royal Bank of Scotland plc* [2012] EWHC 3661 [88]
[599] FSMA 2000 s384(1)
[600] FSMA 2000 s404(1)

product such as a cap or a plain swap with the break cost less than 7.5% of nominal amount of IRHP.[601] The difference in the causation test employed by the regulator from the one used by the court is that the regulator assumed its own prospective result (7.5% break cost and a simple product) even when circumstances led to the conclusion that the consumer would still have bought an IRHP even without the bank's breach of regulatory requirements. In fact, the answer to the question of "how would the consumer have acted if the financial institution had not breached the duties?" is probabilistic in that no one can answer with in certainty.[602] The regulator pursues a "fair" answer to this challenging question, within the range of reasonableness.[603]

5.2 Origins of the dissonance

Above section 5.1 has looked at the dissonance of principles and rules between private law and regulation in dealing with the claim of "mis-selling" of over-the-counter derivatives. As the next stage, this section will try to find the reasons why there are contrasting dissonance in the two institutions. The first reason is that the functions the society expects the two institutions to undertake are different. The second reason is that even with their different functions, the roles of the two institutions are overlapping more and more and this results the collision of the different rules of the two institutions. The next sections will examine these reasons.

5.2.1 Different functions of the two institutions

5.2.1.1 The function of private law

[601] See n347
[602] P Laleng (n 585) 103; see also Financial Ombudsman Service, 'Final Decision on complaint by the W family' (2013) 19 < www.financial-ombudsman.org.uk/.../swaps-bankE-prov-decision.pdf> accessed 3rd April 2016
[603] Stephen D Sugarman (n 587) 146

Before starting to discuss the function of private law, it is necessary think about transactions and contracts in general. Since human beings started having production surplus, transactions between individuals have existed.[604] In an economic perspective, a transaction tends to cultivate mutual benefit to the participants.[605] If it were not beneficial to both parties, the transaction would not be concluded because the party who would suffer loss from the transaction would decline to enter into the deal. Let's say that a house which has £9,500 utility to the current owner has £10,500 utility to someone else. If they agree to transact the house at a price of £10,000, each party gets a £500 utility increase. Social welfare, the aggregate of the utility, can be said to increase by £1,000. As the resource (house) is being used in society by one who can use it with higher utility, the transaction results in a more efficient allocation of resource. Therefore, it can be deduced that, without transaction costs, economic resources will be transacted eventually to reach the person for whom the value of the resource is the largest in society and so, it is argued, an overall increase of transactional activity means improvement of social welfare.[606]

Transactions are usually carried out by contracts in the modern market economy,[607] and contracting incurs transaction costs in negotiating, formulating and enforcing contracts. Private law plays a facilitative role for contracting by enabling transactions to happen with minimal costs and by enforcing contracts.[608] Contract law is said to have functions of

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[604] Adam Smith, *The Wealth of Nations* (1937) 13; Anthony I.Ogus, *Regulation: Legal Form and Economic Theory* (Hart Publishing 2004) location 1332 (Kindle edition)
[605] Milton Friedman, *Capitalism and Freedom* (University of Chicago Press 1962) 13; Michael J. Trebilcock, *The Limits of Freedom of Contract* (Havard University Press 1997) 7
[606] Klaus Mathis, *Efficiency Instead of Justice. Searching for the Philosophical Foundations of the Economic Analysis of Law* (Springer 2009) location 657 (kindle edition)
[607] K.LLEWELLYN, 'What Price Contract-An Essay in Perspective' in A.I. Ogus and C.G. Veljanovski, *Readings in the Economics of Law and Regulation* (CLARENDON PRSS 1984) 149-150
[608] Péter Cserne, *Freedom of Contract and Paternalism: Prospects and Limits of an Economic Approach* (Palgrave Macmillan 2012) 88; Werner Z Hirsch, *Law and economics: an introductory analysis (*Academic press 2015) 130

rendering "doing transactions" efficient by reducing contracting costs[609] in negotiating and formulating contracts by providing implied terms[610] and common vocabularies[611] for contracting, without which contracting parties should spend quite large amount of time and energy in defining "vocabularies" and negotiating terms for all contingencies.[612]

Contract law is also the last resort for enforcing contracts. Enforcement is a critical factor in facilitating contracting because it convinces parties to enter into contracts by ensuring that the obligations in the contracts be completed.[613] Incentives of maintaining reputation aids self-policing and enforcement by contracting parties but the extent of this is limited because reputational capital is finite.[614] One commentator called this enforcement function of private law as 'containing opportunism in non-simultaneous exchanges'.[615]

Without a compulsory mechanism to enforce contracts and institutions to reduce transaction costs in contracting, contracting will be deterred and levels of welfare could stagnate at individual and social level. Private law is needed to provide an institutional supportive role for facilitating transactions and to minimize the intervention on

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[609] Richard A. Posner, *Economic Analysis of Law* (6th edition, Aspen Law and Business, 1998) 108; Werner Z Hirsch, *Law and Economics: An Introductory Analysis* (Elsevier Science 2015) 130

[610] Richard A. Posner, *Economic Analysis of Law* (n 609) 96; Anthony I.Ogus (n 607) n 5 (Chapter 2)

[611] Alan Schwartz, 'Contract theory and theories of contract regulation' in Eric Brousseau and Jean-Michel Glachant (eds), *The Economics of Contracts* (CAMBRIDGE UNIVERSITY PRESS 2002) location 1587 (kindle edition)

[612] Anthony T. Kronman and Richard A. Posner, *The Economics of Contract Law* (Little, Brown and Co. 1979) 4

[613] Alan Schwartz, 'Contract theory and theories of contract regulation' in Eric Brousseau and Jean-Michel Glachant (eds), *The Economics of Contracts* (CAMBRIDGE UNIVERSITY PRESS 2002) location 1587 (kindle edition)

[614] Benjamin Klein, 'The role of incomplete contracts in self-enforcing relationships' in Eric Brousseau and Jean-Michel Glachant (eds), *The Economics of Contracts* (CAMBRIDGE UNIVERSITY PRESS 2002) location 825 (Kindle edition)

[615] Michael J Trebilcock (n 605) 16

contracting.[616] Posner explained this aspect of private law by saying that private law is concerned with "efficiency".[617]

In law of contract, freedom of contract is a fundamental principle for its facilitative role for contracting.[618] Freedom of contract is the 'freedom of choice' with respect to both contracting counterparties and contracting terms.[619] This principle is based not only on the philosophical value of 'individual autonomy' but also the belief that each individual would act in his best interest and always seek to increase his welfare.[620] In the previous house transaction example, the seller and buyer can maximize their utility by freely agreeing on any terms such as guarantee for fixing defects, apportioning costs and payments, etc. That is the reason why private law allows individuals freedom to contract what they need and ensures, once agreements are concluded, that they are to be kept ('*pacta sunt servanda*').[621]

It is also argued that *caveat emptor* is a principle whereby efficiency is enhanced through encouraging production of information in society. In its nature, information is expensive to make but cheap to deliver. If contracting parties are not allowed to make a profit by keeping to themselves information they make or have, they are not motivated to make

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[616] Adams and R.Brownsword, 'The ideologies of Contract Law' (1987) 7 *Legal Stud.*205, 206-208
[617] Richard A. Posner, *Economic Analysis of Law* (n 609) 24; Richard A Posner, 'A Reply to Some Recent Criticisms of the Efficiency Theory of the Common Law' (1981) 9 Hofstra Law Review 775, 776; Anthony T. Kronman and Richard A. Posner, *The Economics of Contract Law* (Little, Brown and Co. *1979)* 5
[618] Péter Cserne (n 608) 81; Adams and R.Brownsword (n 616) 208
[619] Péter Cserne (n 608) 81
[620] Ibid P83
[621] Klaus Mathis, *Efficiency Instead of Justice. Searching for the Philosophical Foundations of the Economic Analysis of Law (Springer 2009)* Location 1012 (Kindle edition)

information.[622] And this can result in information production below the optimal level for a society.[623]

When looking back at the cases of over-the-counter derivatives, one of the most important things to the court was the contractual terms.[624] As an enforcer of contracts, the court should enforce the contractual terms, in general. In consequence, the court has to uphold the contractual terms which deny provision of any advice or representation about over-the-counter derivatives regardless of the pre-contractual negotiations, because the contractual terms are the "efficient" result of negotiation about risk allocation between independent parties. Under the principle of "*caveat emptor*", the liability of financial institutions from omitting to explain facts or features of over-the-counter derivatives is not upheld.

Here, it is necessary to point out one of the features of private law, the 'generality', which allows private law to encompass most transactions in a vast array of areas.[625] This generality permits the court to deal with most transactions in its system.[626] The generality also provides contracting parties with the freedom of contract because they can adjust their contracts to their specific needs rather than adapt their transactions to the legal framework.[627] While generality empowers private law with expandability, it restrains, on the other hand, private law from differentiating itself in market failures described below.[628] The court is bound to sustain the consistency in its adjudications through time and across

[622] Richard A. Posner, *Economic Analysis of Law* (n 609) 111
[623] Ibid
[624] See n375
[625] Hugh Collins, *REGULATING CONTRACTS* (Oxford, 1999) 46
[626] Ibid
[627] Ibid 47
[628] Ibid

jurisdictions to maintain doctrinal stability.[629] Private law cannot make special provision other than its generally applicable principles just for a certain area such as financial products transactions.

There are some prerequisites in order to be able to say that transactions enhance welfare of individuals and whole society. The first one is adequate information.[630] This means that individuals should hold or be able to obtain necessary information to understand what the best choice is for him. If he does not have enough information about a transaction, he can do a transaction which decreases his welfare. The second prerequisite is that the contracting party should be rational, which means he acts in his best interest.[631] Even though the contracting party has sufficient information, he can do a contract or transaction that can decrease his welfare as well if he has bounded rationality in processing the information.[632] This issue will be discussed in the next section.

5.2.1.2 The function of regulation

(1) Market failures

The previous section shows that private law facilitates transactions, which enable individuals to seek their best interest and welfare and as a result improve the overall level of social welfare. But the proposition that individual and social welfare is improved by transactions is based on the assumption that participants in the market have enough information about the transactions and are rational enough to act in their best interests. If these conditions are not fulfilled, freedom of contract cannot guarantee welfare

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[629] Andrew Robertson, 'Constraints on Policy-Based Reasoning in Private Law in Robertson' in Andrew, and Hang Wu Tang (eds), *The goals of private law* (Bloomsbury Publishing 2009) 261-280

[630] Milton Friedman, *Capitalism and Freedom* (1962) 13; Anthony I.Ogus, *Regulation: Legal Form and Economic Theory* (n 604) para 2.5

[631] Richard A. Posner (n 609) 1; C.G. VELJANOVSKI, 'The New Law-and-Economics: A Research Review' in A.I. Ogus and C.G. Veljanovski, *Readings in the Economics of Law and Regulation* (CLARENDON PRSS 1984) 16

[632] Richard A. Posner, *Economic Analysis of Law* (n 609) 5; C.G. VELJANOVSKI (n 631) 16; Michael J. Trebilcock (n 605) 118-119

improvement through transactions but can sometimes rather deteriorate welfare.[633] With respect to the previous example of a house transaction, if the purchaser is not aware of defects of the house such as ground subsidence (information defects) or if he buys the house with an unrealistic expectation of price increase in near future like some US subprime mortgagors prior to the market meltdown (bounded rationality), the transaction of the house would decrease the purchaser's welfare. The following parts will examine market failures such as information defects and bounded rationality in the financial services market.

Information defects

When consumers undertake financial transactions, they need 'multi-dimensional' information and knowledge about the products and the related market.[634] For example, when entering into an interest rate hedge contract, the consumer needs to decide the various conditions such as the product type, maturity, right of early exit, etc. This decision process requires him to synthetize and take account of his financial situation, the product features and the future market expectation.[635] Then there has to be a consideration about whether the characteristics of the product fit well with the expected future market movement and his financial situation. In sum, the decision of whether to execute a financial transaction, especially complex ones, requires substantial level of expertise, knowledge and the ability to integrate many different kinds of information.

Obtaining necessary information and knowledge is not usually impossible but costly.[636] The information searching process costs consumers plenty of time and effort. For instance, consumers may find it very difficult to quote contract conditions for currency over-the-

[633] Michael J Trebilcock (n 605) 102-103
[634] David Llewellyn, *The economic rationale for financial regulation* (Financial Services Authority 1999) 24
[635] See n370
[636] Kristine Erta et al, *Applying behavioural economics at the Financial Conduct Authority* (FCA, 2013) 24

counter derivatives from a bank without previous relationship.[637] The high search cost may make customers give up looking for alternative information providers or products. Empirical research on retail consumers in the EU member states showed that only 33% of investors who made investment in financial products compared with products of other providers or different products of the same provider.[638] This shows that consumers are likely to be dependent on the financial institution.[639] In addition, a consumer's dependency on the financial institution impose a high cost on him when provider-switching happens because he has to abandon the cost that has been invested to build up relationship with the previous provider.[640] Oral or written explanations by representatives of financial institutions would be the main source of information for product features.[641] Consumers' expectation about market movement can be heavily influenced by the opinions of the representatives of financial institutions.[642] In transactions of over-the-counter derivatives, even large corporate clients would substantially rely on the explanation by the financial institution about the product features because over-the-counter derivatives are designed by the financial institution.[643] Information asymmetry and the consumer's reliance on the financial institution for necessary information serve as practical barriers for consumers to find the best products satisfying their needs.

Bounded rationality

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637 See n83

638 Nick Chater et al, 'Consumer Decision-Making in Retail Investment Services: A Behavioral Economic Perspective' (2010) Report to the European Commission/SANCO 7

639 Christine Cuccia, 'Informational Asymmetry and OTC Transactions: Understanding the Need to Regulate Derivatives' (1997) 22 Del. J. Corp. L. 197, 200-201

640 European Capital Markets Institute and Centre for European Policy Studies (n 253) p124; Great Britain H. M. Treasury, *Reforming financial markets* (The Stationery Office, CM 7667, 2009) para 9.5

641 See n370

642 See eg *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518

643 Christine Cuccia (n 639) 200-201; also see *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518

It is now broadly accepted that people do not always make rational decisions.[644] Since behavioural economics research emerged, much theoretical and empirical research has been conducted which supports this. In essence, behavioural economics posits that human beings have two thinking systems, intuition and reasoning, and that people use intuition for the questions requiring reasoning.[645] This lies at the heart of what economists term 'bounded rationality'.

Research has also found investors' bounded rationality in their decisions on financial transactions.[646] Bounded rationality of consumers can affect their decision on financial transactions in the following ways: many financial products are inherently complex for ordinary people, which make them simplify their investment decisions with errors; while decisions of buying financial products need assessment of risk and uncertainty, people tend to use intuition in assessing; many financial products are credence products which are products or services whose value and quality cannot be assessed even after its use, and so it is difficult to learn from mistakes.[647]

Among types of bounded rationality found when consumers make financial transactions, at the stage of deciding preferences, they show the 'presence bias' which is the attitude

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[644] Kahneman and Tversky, 'Judgment under uncertainty: heuristics and biases' (1974) 185 Science 1124, 1124 -1131

[645] Ibid

[646] Financial Supervisory Authority, 'Financial Services: A Behavioral Economic Perspective' (2010); David de Meza et al, 'Motivating better consumer decisions through behavioral Capability: A Behavioral Economics Perspective' (2014) < http://www.lse.ac.uk/researchAndExpertise/researchImpact/caseStudies/demeza-reyniers-consumer-decisions-behavioural-economics.aspx> accessed June 2016; Nick Chater et al, 'Consumer decision-making in retail investment services: A behavioural economics perspective' (2014) Report to the European Commission/SANCO; Dimity Kingsford Smith and Olivia Dixon, 'The Consumer Interest and The Financial Market' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (OUP Oxford 2015) n92

[647] Kristine Erta et al, *Applying behavioural economics a*t the Financial Conduct Authority (FCA, 2013) 16; John Y.Campbell et al, 'Consumer Financial Protection' (2011) 25.1 The Journal of Economic Perspectives 91, 91, <http://www.ncbi.nlm.nih.gov/pmc/articles/PMC4076052/pdf/nihms311044.pdf> accessed 14th May 2016

of overvaluing the present over the future.[648] In the recent interest rate hedging products scandal, it was observed that many consumers preferred a swap without an up-front fee to a collar with up-front fee without assessing the risk profile of each product.[649] At the stage of decision-making, they are vulnerable to influences from advisers or salespersons.[650] They show a tendency to give trust to the salesperson based on his likable traits not on objective information such as historic performance data or economic incentive structure.[651] They are also biased by over-confidence that their investment will perform well without rational reasons.[652] In summary, behavioural research in financial services industry shows that consumers make errors in the process of making investment decisions systematically due to their bounded rationality.

Summary

Above parts showed that information defects and bounded rationality undermines the preposition that consumers can increase their welfare through financial transactions. Private law as a facilitator of transactions, however, has structural weaknesses to adequately intervene in market failures.[653] Posner pointed out that market failures are also the failures of common law.[654]

Firstly, the principles for facilitation of private law set limits to ameliorate market failures.[655] For instance, '*caveat emptor*' which put the responsibility of realizing the risk of the

[648] David de Meza et al (n 646) 17
[649] See n314
[650] David de Meza et al (n 646) 18
[651] Ibid 19
[652] Ibid 18
[653] See n628; Atiyah, Patrick Selim, and Patrick S. Atiyah, *The rise and fall of freedom of contract* (Vol. 61. Oxford: Clarendon Press, 1979) 703
[654] Richard A. Posner, *Economic Analysis of Law* (n 609) 383, 389
[655] Anthony I.Ogus, *Regulation: Legal Form and Economic Theory* (n 604) Section 2.6

transaction on the consumer cannot solve the information asymmetry. In terms of bounded rationality, private law implicitly, if not explicitly, has the principle of 'equality and equivalence between individuals' and so cannot give 'favourable treatment' to consumers.[656] Secondly, the limitations of private law come from high legal costs associated with its use.[657] High litigation expense coupled with the uncertainty of the adjudication has deterred consumers from pursuing compensation by private law.[658] For instance, a litigation cost of £700K to a SME which suffered a loss of £3.5 million from IRHPs would be beyond financial capability of majority SMEs.[659]

(2) Function of regulation

Regulation is a political response to market failures and to the limited capability of private law to address the failures.[660] To counter information asymmetry between consumers and financial institutions, regulation requires financial institutions to provide all appropriate information for consumers to make investment decisions on an informed basis[661] and to communicate in fair, clear and not misleading way[662]. In order to counter consumers' bounded rationality, the suitability rule was adopted. This rule requires financial advisers to know the client and then recommend only suitable products to them.[663] Furthermore, when providing service on an execution basis without any advice, financial institutions should assess whether the consumers' knowledge and experience is appropriate to

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656 Ibid
657 Ibid
658 Ibid
659 House of Commons Treasury Committee, 'Conduct and competition in SME lending' (2015) 62
660 Edward L. Glaeser and Andrei Shleifer, *The rise of the regulatory state* (No. w8650. National Bureau of Economic Research, 2001) 5, 13, 34
661 FCA Handbook, COBS 2.2.1(1)R
662 FCA Handbook, COBS 4.2.1R
663 FCA Handbook, COBS 9.2

understand the risks of products demanded.[664] The suitability rule and appropriateness rule can be said to protect consumers from their errors caused by their bounded rationality. In the end, regulatory duties as onerous as the fiduciary duties in private law are imposed on financial institution.[665] In summary, the different responses to market failures has made the dissonance of standards between the two institutions.

(3) Motivation of regulation

The above section examined the function regulation undertakes for consumer protection in the financial services market. This section will consider what is the motivation of promulgating regulation. Ostensibly, regulation makers justify adoption of a new regulatory rule by explaining that it is necessary for public interest.[666] This is in line with the cost-benefit analysis the FSMA 2000 requires the regulator to undertake when introducing a new regulatory rule.[667] However, this is the story on the surface. The debate on the motivation of making regulation has continued for decades. One side has claimed that regulation is made for the general good ('public interest theory') and the other side has claimed that it just comes from the intention of some groups to use the government power for their advantage ('private interest theory'). The below parts will examine the two theories and show implications related with the dissonance between private law and regulation.

Regulation for public interest

Public interest theory explains that regulation is demanded and promulgated for public interest which the market system including private law cannot protect from market

[664] FCA Handbook, COBS 10.2.1R
[665] See n570
[666] Levine, Michael E., and Jennifer L. Forrence, 'Regulatory capture, public interest, and the public agenda: Toward a synthesis' (1990) 6 Journal of Law, Economics, & Organization 167, 168
[667] FSMA 2000 s 138I

failures.[668] It asserts that regulatory intervention is necessary to protect public interest from market failures.[669] This theory explains that regulation increases social welfare by correcting market failures and so represents the 'public interest'.[670] Market failures can range from monopoly, externalities and information defects including bounded rationality in processing information.[671] This theory underlies the rationales offered by legislators or regulators when they propose and justify introducing new forms of regulation.[672]

However, 'public interest' theory has a problem in that it offers no explanation about how "public interest" is perceived by legislators and moulded into regulation.[673] There is no link guaranteeing that legislators will pursue the regulation maximizing social welfare; a voting system through which individual preference is determined cannot ensure the 'public interest' is achieved because the policy that majority of voters vote for may put more cost on the remaining minority compared with the benefit the majority will gain,[674] while welfare maximization is possible by individual transactions in the market system.[675]

Regulation for private interest

Private interest theory assumes that individuals or groups pursue regulation as a way for maximizing their private interest.[676] The basic idea of the theory is that regulation is a product made by regulators (politicians or bureaucrats of regulatory agency) for those who

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668 Anthony I.Ogus, *Regulation: Legal Form and Economic Theory* (n 604) 29

669 Stephen Breyer, 'ANALYZING REGULATORY FAILURE: MISMATCHES, LESS RESTRICTIVE ALTERNATIVES, AND REFORM' (1978-1979) 92 Harv. L. Rev. 547, 553

670 Browen Morgan and Karen Yeung, *An Introduction to Law and Regulation: text and materials* (Cambridge University Press 2007) 18

671 Anthony I.Ogus, 'Whither the economic theory of regulation? What economic theory of regulation?' in Jordana, Jacint, and David Levi-Faur (eds), *The politics of regulation: institutions and regulatory reforms for the age of governance* (Edward Elgar Publishing 2004) 32

672 See n666

673 Anthony Ogus, 'Whither the economic theory of regulation? What economic theory of regulation?' (n 671) 32

674 Ibid 34

675 See n606

676 Browen Morgan and Karen Yeung (n 670) 43

can benefit from the regulation.[677] Private interest groups such as industries or occupations with different voting or financial capability to mobilize political power enter into the 'political market' to gain benefit from regulation.[678] The regulators, suppliers of the regulation, demand in exchange for beneficial regulation the political support for them to stay in their office.[679]

Implication

The question of whether regulation in the financial services industry is for "public interest" or "private interest" is a complex and multi-facet one and is beyond this thesis. But the theories of regulatory motivations give an implication. According to the two competing theories, regulation is produced to provide for the interests of people, whether they are the general public or private groups, which cannot be secured without regulation. This means that interests which regulation intends to protect cannot be protected by private law and that's why regulation is promulgated. Therefore, these theories show that regulation cannot help but have a degree of dissonance with private law.

5.2.2 Overlapping roles of the two institutions

The above section 5.2.1 examined the different functions of private law and regulation and found that regulation intends to provide interests, which cannot be protected by private law. The different functions of the two institutions cause the dissonance in their principles and rules, as seen in section 5.1. However, if the territories of the two institutions are completely separate, the dissonance will not be revealed distinctly. Overlapping roles of the two institutions is a recent one caused by financial regulation expanding its roles. The

[677] George J. Stigler, *The citizen and the state: Essays on regulation* (Vol. 834. Chicago: University of Chicago Press 1975) 113-119

[678] Ibid xi

[679] Stephen Croley, 'Theories of regulation: Incorporating the administrative approach' [1998] Columbia Law Review 1, 35

expanding role of financial regulation can be explained as a part of the great tide of 'the rise of the regulatory state', which commenced from 1980s when Britain started restructuring its economy after economic crises in 1960s and 1970s.[680] In terms of financial regulation, it transformed self-regulation by elite "clubs" of financial institutions to statutory regulation in 1986 by FSA1986 enactment.[681] Under self-regulation, regulatory action was informal and non-legal such as adverse publicity and exclusion from the membership of the "club".[682] Thus, self-regulation did not have many chances to collide with private law. However, as a single statutory authority appeared and financial regulation stretched its reach from informal and non-legal controls to formal and legal enforcement through FSA 1986, FSMA 2000 and the COBS intelligently copied from MiFID, the contradicting aspects between the two institutions have been revealed.

In addition, the powers conferred on the regulator have also been expanded. Historically in Britain, there have been separate roles between private law and regulation: private law focused on compensation and regulation focused on deterrence.[683] But in the 'rise of the regulatory state', regulation has evolved from its original aim of remedying a specific market failure to regulating 'social' risk which can affect 'whole populations'.[684] This ambitious aim created many large bureaucratic regulatory agencies,[685] which in turn made the government keen to improve the effectiveness of regulation enforcement. Based on the initiatives of the government, many researches were conducted and proposals made

[680] Michael Moran, 'The rise of the regulatory state in Britain' (2001) 54.1 Parliamentary Affairs 19, 20
[681] Michael Moran (n 680) 20
[682] Graham F. PIMLOTT (n 135) 148
[683] Christopher Hodges, 'Developing Approaches to Public and Private Enforcement In Englnad and Wales' in Fabrizo Cafaggi, Hans-Wolfgang Micklitz (eds), *New Frontiers of Consumer Protection* (Intersentia Publishers 2009) 151
[684] Michael Moran (n 680) 24
[685] Michael Moran (n 680) 25

to increase the effectiveness of regulation.[686] Among them, a report in 2006 by Professor Macrory to the government for reforming regulatory sanction included "restoring harm caused by regulatory non-compliance" as one of its Six Penalties Principles.[687] With this report adopted, many regulators other than the financial regulator were given a right to request compensation orders to the court,[688] even though in financial services industry, the boundary of separated roles already had begun to be diluted when the Gower report[689] proposed effective enforcement of regulation that the power to proceed consumer compensation of loss resulted from regulatory breach of financial institutions should be given to the financial regulator[690] and even consumers[691], which was adopted by the FSA 1986.

As seen above, the commencement of regulatory compensation was for effective enforcement of regulation and still the FCA officially states that the main purpose of regulatory compensation is 'credible deterrence', i.e. effective enforcement.[692] However, in the real world, compensation is not just a device to improve effectiveness of regulatory enforcement but is one of the major independent roles of financial regulator. The below comments the FSA shows well the society's expectation of its proactive role for compensation:

> Our experience is that members of the public and Parliamentarians have been of the view that - as a matter of public policy – the breach of the FSA's rules should in all cases entail the consumer receiving 100% redress. However, the

[686] See eg Better Regulation Task Force, *Principles of good regulation* (1998); see Philip Hampton, *Reducing administrative burdens: effective inspection and enforcement* (HM TREASURY, 2005)
[687] Richard B.Macrory, *Regulatory Justice: Making Sanctions Effective* (Cabinet Office, 2006) 31
[688] Christopher Hodges, 'Developing Approaches to Public and Private Enforcement In Englnad and Wales' (n 683) 166
[689] See n154
[690] FSA 1986, s 61
[691] FSA 1986, s 62
[692] Financial Conduct Authority, 'The FCA's approach to advancing its objectives' (FCA, 2013) 19

> FCA's ability to ensure that consumers receive redress is constrained by the general law… If society expects as a matter of public policy that the regulator should be in a position to require greater levels of redress to be paid then the FCA needs to be given a clear mandate and powers to do so in the new legislation. This is a difficult issue that gives rise to real questions as to how far the regulator's powers should extend and we would very much welcome the Committee debating this matter, in particular to achieve further clarity as to the FCA's mandate in this area.[693]

For example, the financial regulator has demanded the financial institutions to make compensation to its consumers suffered by their regulatory breach by lowering the sanction level in consideration of compensation.[694] In the IRHPs scandal, the regulator organized a sales practice review of IRHPs, stating that the core purpose of the review was to pay 'fair and reasonable redress to customers where appropriate'. In the IRHPs scandal, what parliament[695] and an interest group[696] demanded of the regulator the most was fair regulatory compensation. Difficult accessibility to private law system is one cause of this demand.[697] So a simple dichotomy separating regulation for deterrence and private law for compensation is not true anymore.[698] Regulation with dissonant standards with private law gets involved in "compensation" which has been supposed to be the role of private law.[699]

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693 Financial Supervisory Authority, 'Joint Committee on the Draft Financial Services Bill Memorandum from the Financial Services Authority' (2011) para 33-34 <www.fsa.gov.uk/pubs/other/pls.pdf>

694 Financial Services Authority, 'FINAL NOTICE to Savoy Investment Management' (2012) para 2.7.(4); Financial Services Authority, 'FINAL NOTICE to Credit Suisse UK', 2.5.

695 House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n333) 36-65

696 Bully-Banks was created in December 2011 by business owners each of whom had been mis-sold Interest Rate Hedging Products. <http://www.bully-banks.co.uk/site/> accessed 15 May 2015

697 House of Commons Treasury Committee (n 695) 62; see also TT ARVIND and JOANNA GRAY, 'The Limits of Technocracy: Private Law's Future in the Regulatory State', 13-14

698 Fabrizio Cafaggi, *A coordinated approach to regulation and civil liability in European Law: Rethinking institutional complementarities* (European University Institute 2005) 194-195; Rose-Ackerman S, *Rethinking the progressive agenda* (Simon and Schuster 1993) 118

699 TT ARVIND and JOANNA GRAY (n 697) n15

Lastly, another reason for overlapping roles between private law and regulation is the European Union's regulation-oriented policy. Majone explained that the European Commission, with limited bureaucracy and budget, chose regulation as a device for pursuing its policy goals efficiently.[700] The Commission promulgates general regulatory framework and standards and imposes the duty of enforcing the regulation on each member state.[701] MiFID was also implemented as a regulation, the COBS, in the UK.[702] Regulatory rules for consumer protection of MiFID and the COBS such as suitability rule deal with the contractual relationship between financial institutions and consumers and allocate rights and obligations in the relationship, all of which traditionally used to be the role of private law.[703] Regulation resulted in regulating contractual relationship which is the major role of private law.[704] P.O. Mülbert has described this phenomenon as a 'partial eclipse of contract law'.[705]

Regulation, however, does not set out to override rules of private law.[706] FSMA 2000 expresses that contravention of regulatory rules does not make a contract void or unenforceable.[707] Regulation, while pursuing its objective of consumer protection, tries to confine its impact to only what is necessary to achieve its objectives in order not to intrude into the territory of private law. This stance was well illustrated by the opinion HM Treasury

[700] Giandomenico Majone and Pio Baake, *Regulating Europe* (Psychology Press 1996) 66
[701] Ibid
[702] Guido Ferrarini, 'Contract standards and the Markets in Financial Instruments Directive (MiFID): An assessment of the Lamfalussy regulatory architecture' (2005) 1.1 European Review of Contract Law 19, 20-21
[703] Grundmann, Stefan, and Jörg Hollering, 'EC Financial Services and Contract Law–Developments 2005–2007' (2008) 4.1 European Review of Contract Law 45, 62
[704] TT ARVIND and JOANNA GRAY (n 697) n4
[705] P.O. Mülbert, 'The Eclipse of Contract Law in the Investment Firm-ClientRelationship: The Impact of the MiFID on the Law of Contract from a German Perspective', in G. Ferrarini & E. Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond* (Oxford University Press 2007) 320
[706] Olha O Cherednychenko, 'European securities regulation, private law and the investment firm-client relationship' (2009) 17.5 European Review of Private Law 925, 930
[707] FSMA 2000 s138E(2)

and the FSA presented as to the question 'What is your opinion on introducing a principle of civil liability applicable to investment firms' in the process of MiFID review:

> In introducing a principle of civil liability we think that it is necessary to be careful about disturbing existing legal systems. We think that it would be better to require Member States to impose liability on investment firms for which they are the Home Member State than to attempt to impose a harmonised standard of liability. It would be difficult to achieve agreement on the latter and the end result could work awkwardly in some jurisdictions. We also believe that careful consideration needs to be given to scope of a principle of civil liability. In the UK the principle has more or less been restricted to investment firms' dealings with natural persons. This has reflected an effort to strike a balance between investor protection and the legal risk of providing investment services.[708]

In other words, the government tries to enhance consumer protection in the financial services market failures by regulation but intends to refrain it from expanding too much into the sphere of private law. Confining regulation in the public sphere is one of the reasons why the dissonance of requirements between private law and regulation continues.

Conclusion

This chapter has compared principles and rules applied by private law and regulation in transactions of over-the-counter derivatives between financial institutions and consumers and found clear cases of dissonance between private law and regulation. It is found that regulation requires a higher level of loyalty and care of financial institutions with regards to consumers than private law. The requirements of regulation are similar to fiduciary duties in private law. Financial institutions tend to avoid a fiduciary relationship with their

[708] HM TREASURY and FSA, 'UK response to the Commission Services consultation on the Review of the Markets in Financial Instruments Directive (MiFID)' (2011) 79 <https://circabc.europa.eu/d/d/workspace/SpacesStore/74845825-a382-40d1-93e8-7ff334ff6a12/Joint%20Response%20-%20UK%20Treasury%20%26%20FSA.pdf> accessed 21 July 2016

consumers in private law, due to the onerous obligation and so prepare the standard forms of contract to contract the obligations out. However, obligations of regulation, which have originality from fiduciary duties of private law, cannot be modified by contract. Therefore, one of the reasons for the dissonance in requirements between the two institutions is fiduciary duties of financial institutions, which are imposed mandatorily in regulation but are excluded by contractual terms in private law.

In causation test for deciding compensation, there was also dissonance found between the two institutions. Private law focuses on finding the "precise" factor that caused the loss. It tries to rule out other factors such as policy goals in deciding causation. On the contrary, regulation pursues a "fair" result in causation in the boundary of the reasonableness allowed. In essence, through causation test, private law pursues "corrective justice" while regulation does "distributive justice".[709]

The reasons of the dissonance in principles and rules of the two institutions can be found in their different functions undertaken. Their different functions can be explained based on the market system. The market system is based on the assumption that transactions will improve the welfare of both transacting parties. The overarching function of private law is to facilitate contracting which is a major type of transaction in modern society. As a facilitator of the market system, private law's role is to reduce transaction costs such as costs of negotiating, formulating and enforcing contracts. Many principles in private law such as "contract of freedom", "*pacta sunt servanda* " and "caveat emptor" originated from the contract-facilitating function.

[709] Ernest J. Weinrib, *Corrective justice* (OUP Oxford 2012) para 15-16

However, market failures undermine the assumption that a transaction improves welfare of transacting parties. Among market failures, information defects and bounded rationality of consumers are found in financial products transactions. The function of regulation is correcting the market failures and private law failures[710] of remedying market failures. For protection of consumers with information defect and bounded rationality, which are not addressed by private law, conduct of business rules in regulation adopted fiduciary duties of financial institutions, the extent of which cannot be modified by contracts.

The dissonance is revealed more clearly as the roles of the two institutions overlap. In the huge flow of the "rise of regulatory state", regulation has become official and legal and expanded its roles into compensation which is a major role of private law. Thus, different principles and rules of private law and regulation are applied to the same issue and create different results.

With the understanding of dissonance and its reasons, the next Chapter will discuss what should be done about the dissonance.

[710] Fabrizio Cafaggi (n 698) 192-195; Atiyah, Patrick Selim, and Patrick S. Atiyah (n 653) 703

VI. COMPLEMENTARY INTERPLAY BETWEEN PRIVATE LAW AND REGULATION

Introduction

The previous Chapter has showed that there is dissonance in standards between private law and regulation and has examined the origins of this dissonance. In this Chapter, consideration will be given to the manner in which the two institutions operate: are they complements or alternatives? It has already been explained that the traditional perspective of separating regulation's role as a deterrence mechanism and private law's as primarily a compensatory mechanism is no longer appropriate and the roles of deterrence and compensation belong to both institutions.[711]

What can be implied from the fact that both institutions have similar functions is that there is potential to complement each other to improve the effectiveness of their functions.[712] However, similar functions do not guarantee complementarity; it can rather be counter-effective. So this Chapter, firstly, will examine whether there is complementarity between the functions of the two institutions.

Secondly, the Chapter will discuss the current situation of how private law and regulation interact with each other within the financial services sector. It will consider the effectiveness of legislative attempts to reinforce complementary interplay between the two institutions. Then it will identify the causes hindering harmonized interplay between the two institutions and finally, will explore and suggest remedies for addressing those causes.

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[711] See Chapter V 5.2.2; See also TT Arvind, 'Tortological Question and the Public-Private Relationship in Tort Law' (2010) 7 J. Juris 349, 377

[712] Fabrizio Cafaggi (n 698) 202

6.1 Complementarity between private law and regulation

This section will examine whether there is complementarity between private law and regulation. As having complementarity means that the weaknesses of one institution is supplemented by the other, this section will consider the strengths and weaknesses of each institution to understand whether complementarity exists.

For a thorough comparison of the strengths and weaknesses of the two institutions, it can be said that any 'regulatory system' including private law and statutory regulation consists of three sub-processes: standard-setting, monitoring and enforcement and intervention.[713] The following discussion provides a comparative analysis of the strengths and weaknesses of private law and regulation with respect to these three sub-processes.

6.1.1 Standard setting

Legal standards can generally be classified into three types: specification standards, performance standards and target standards.[714] Specification standards specify the conduct that the regulated entities should follow, performance standards describe the outcome of the regulated activities and target standards state the regulatory goal.[715] The type of standards provides a starting point for comparing private law and regulation in relation to standard setting.

The standards in private law are most comparable to target standards.[716] Private law does not express pre-defined standards.[717] Instead, its principles are demonstrated through cases in the courts,[718] where a set of general principles are applied to the different, specific

[713] Hugh Collins, *REGULATING CONTRACTS* (n 625) 62; See also Fabrizio Cafaggi (n 698) 205-235
[714] R.Baldwin and M. Cave, *Understanding Regulation: Theory, Strategy and Practice* (Oxford 1999) 118-120
[715] Ibid
[716] Peter Cane, 'Tort law as regulation' (2002) 31 Comm. L. World Rev. 305, 314
[717] Ibid
[718] Hugh Collins, *REGULATING CONTRACTS* (n 625) 81

circumstances of each case by judges.[719] The generality of private law allows a more innovative legal framework for transactions to be developed at the discretion of the contracting parties.[720]

However, as Collins argues, this generality can be a weakness as well because it inevitably creates ambiguity.[721] Nobody can anticipate exactly how the court will apply the general principles to specific cases.[722] Such characteristics render it difficult for parties to be certain about the requirements of private law in advance. Indeterminacy of its requirements creates, to some extent, undesirable uncertainty.[723]

Another weakness in relation to the standard setting of private law is that it is not based on risk-benefit analysis.[724] When an activity is regulated, it is necessary to analyse the risks and benefits of that activity and the trade-offs resulting from the standard.[725] However, private law is not structured to be able to do this[726]; it does not consider, in litigation, the interests of affected third parties;[727] it lacks capability to gather necessary information about the effect of the standard and to incorporate the information into its reasoning process;[728] and the judges have less specialized expertise to evaluate the externalities of the standard.[729]

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719 Ibid
720 Ibid 46-47
721 Ibid 80
722 Ibid 81
723 Pistor, Katharina, and Chenggang Xu, 'Incomplete law'(2002) 35 NYUJ Int'l L. & Pol. 932, 989
724 American Law Institute, *Enterprise Responsibility for Personal Injury* (1991) 87-89
725 Ibid
726 Ibid; Richard B Stewart, 'Regulatory Compliance Preclusion of Tort Liability: Limiting the Dual-Track System' (1999) 88 Geo. LJ 216, 2174
727 Hugh Collins, *REGULATING CONTRACTS* (n 625) 70
728 Hugh Collins, *REGULATING CONTRACTS* (n 625) 85
729 Richard B Stewart (n 726) 2174

Thirdly, when there is considerable inequality of arms between litigants, the standards of private law can be ineffective in "regulating" bad behaviours.[730] The financial market is a key example where an aggrieved consumer will meet in court a financial institution, which has enormous financial capability and is thus likely to be better represented.[731] The standard contract forms for most financial products and services for consumers are good examples that represent the inequality of arms. While financial institutions have legal experts to design standard forms through which to transact business to exclude possible legal liabilities, consumers are not only incapable of examining the risks of the terms and of negotiating change of terms[732] but also show the tendency to not even read the contract terms in detail by term while trusting[733] representatives of financial institution.[734]

The final weakness of private law to highlight is that the standard of private law is slow to respond to changes in the environment.[735] Its slow response to the changing environment is closely related to its generality or insufficient particularity. Differentiation of private law for particular areas with fast changing environments may harm private law's legitimacy.[736] In one aspect, generality can be a strength of private law in that it allows private law to embrace vast areas of transactions and even those that are enormously complex and innovative.[737] However, in areas where the speed of institutional and technological

[730] Andrei Shleifer, 'Understanding regulation' (2005) 11.4 European Financial Management 439, 445
[731] Ibid
[732] Alastair Hudson, *THE LAW OF FINANCE* (n 90) para 25-30; see also Larry Bates, 'Administrative Regulation of Terms in Form Contracts: A Comparative Analysis of Consumer Protection' (2002) 16 Emory Int'l L. Rev.1, 1; Michael J Trebilcock (n 605) 119-120
[733] See n74 and n651
[734] See eg *Peekay Intermark Ltd and another v Australia and New Zealand Banking Group Ltd [2006]* EWCA 386; also see n73
[735] JAMES M. LANDIS, 'THE ADMINISTRATIVE PROCESS' (1938) 95; Allen M Linden, 'Tort Law as Ombudsman' (1973) 51 Canadian Bar Review. 155, 164; Andrew F Tuch, 'Conduct of Business Regulation' (2014) 6 < http://www.valuewalk.com/wp-content/uploads/2015/04/SSRN-id2460966.pdf> accessed on 19 May 2016
[736] Hugh Collins, *REGULATING CONTRACTS* (n 625) 76
[737] Ibid 77

changes are very fast, generality becomes a distinct shortcoming because the general standards of private law have difficulty in keeping in pace with the changes in the specific area.[738] Financial market is an area where there are rapid developments in services, products and processes.[739]

Compared to standard setting in private law, regulation has differences. First of all, regulation involves all three types of standards.[740] For instance, the COBS has a target standard stating that financial institutions should act 'in accordance with the best interests of their clients'[741] (a goal), a performance standard requiring that a communication with a client should be fair, clear and not misleading[742] (an outcome) and a specification standard specifying the steps to be taken to assess the suitability of recommendations[743] (a way). Therefore, regulation is much more descriptive about its intentions and requirements.[744]

Secondly, regulation as standards can pursue any wider social good.[745] While the standard of private law cannot take into account interest of third parties affected, the regulator is able and obliged to perform a social cost-benefit analysis and have regard to opinions of stakeholders when promulgating a new regulatory requirement.[746] The assessment of social impact resulting from a new requirement is possible because the regulator is

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[738] Pistor, Katharina, and Chenggang Xu, 'Law enforcement under incomplete law: Theory and evidence from financial market regulation' (2002) *LSE STICERD Research Paper No. TE442,* 7
[739] Ibid
[740] Peter Cane (n 716) 315
[741] FCA Handbook, COBS 2.1.1.R(1)
[742] FCA Handbook, COBS 4.2.1.R(1)
[743] FCA Handbook, COBS 9.2
[744] Andrei Shleifer, 'Understanding regulation' (n 730) 445; Hugh Collins, REGULATING CONTRACTS (n 625) 79
[745] Andrei Shleifer, 'Understanding regulation' (n 730) 446
[746] See eg FSMA 2000 s 138I; see also Anthony I.Ogus, *Regulation: Legal Form and Economic Theory* (n 604) n54 in Ch.8

equipped with extensive bureaucratic structures with technical expertise[747] to gather and process market information related with the standard.[748]

However, standard setting in regulation is not free from weaknesses. Standards can be used by regulated entities as a device to gain competitive advantage against other competitors or new entrants.[749] Standards can also be distorted from the optimal form due to the influences of politicians and interest groups.[750]

The comparison above highlights complementarities in standard-setting between the two institutions. Uncertainty of private law can be complemented by the specific and clear requirements of regulation. Regulation's capability of assessing externality can make up for the lack of the risk-benefit analysis function of private law. Private law's inability to take into consideration the inequality of power between parties can be remedied by regulation's proactive role in defining the contractual relationship in a particular sector.[751]

6.1.2 Monitoring

Monitoring is the activity of detecting non-compliance with standards by or on behalf of the standard-setter.[752] Regulators conduct inspection and audit as typical techniques of monitoring.[753] They can also monitor through information received from alternative dispute resolution bodies, such as the Financial Ombudsman Service.[754]

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[747] Hugh Collins, *REGULATING CONTRACTS* (n 625) 82-83
[748] Ibid; Andrei Shleifer, 'Understanding regulation'(n 730) 446
[749] George J. Stigler, 'The Theory of Economic Regulation', 2 Bell J. Econ. & Mgmt. Sci.3, 3
[750] George J. Stigler, *The citizen and the state: Essays on regulation* (Vol. 834. Chicago: University of Chicago Press, 1975) 114-119 ; Matthew C Stephenson, 'Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies' [2005] Virginia Law Review 93, 129; see n676
[751] See n703; see also Olha O Cherednychenko, 'European securities regulation, private law and the investment firm-client relationship' (2009) 17.5 European Review of Private Law 925, 929
[752] Peter Cane (n 716) 315
[753] Ibid
[754] FSMA 2000 s232A

What the regulator monitors is not limited to misbehaviours from which a detriment has already occurred. It can detect and sanction misbehaviours which have the potential to result in detriments. For instance, the FSA sanctioned financial institutions for failures in internal controls without any detriments occurring to consumers.[755] Pre-emptive monitoring is an advantage of regulation in that it can correct misbehaviours before detriments occur. Such a proactive approach to monitoring is possible because the regulator can monitor, investigate and sanction on its own initiatives without waiting for a victim to raise an action.[756]

However, there is risk that the monitoring is focused on the areas where the regulator has an incentive to monitor based on its own internal or political agenda.[757] The problem of selective monitoring can be exacerbated by the regulator's limited resources.[758] Hence, socially desirable monitoring cannot be conducted if the area which needs monitoring does not align with the regulator's agenda. For instance, according to the FSA's self-evaluation, socially optimal level of regulatory monitoring and intervention, as the FSA evaluated itself, was not conducted before the global crisis, when the so-called 'light touch' approach of the regulator made it reluctant with rigorous oversight on market players.[759]

In private law, monitoring is not conducted by an agency (the court) but by those affected by the breach of the law.[760] The court's remedy incentivizes them to monitor breaches and bring them to the court. This aspect gives private law an informational advantage in

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[755] See n322; see also Financial Supervisory Authority, FINAL NOTICE to SANTANDER UK PLC (2012)
[756] Pistor, Katharina, and Chenggang Xu, 'Incomplete law' (n723) 935
[757] Matthew C Stephenson (n 750) 119
[758] J. Maria Glover, 'Structural Role of Private Enforcement Mechanism in Public Law' (2011) 53 Wm. & Mary L. Rev. 1137, 1148
[759] Financial Services Authority, 'A regulatory response to the global banking crisis' (Consultation Paper SP09/2, 2009) para 1.63-1.68; see also Alastair Hudson, *Law of Finance* (n 90) Para 7-63
[760] Matthew C Stephenson (n 750) 108

two ways. Firstly, the person affected by breach is better positioned to detect contraventions than the regulator because he is directly affected by the wrongdoing.[761] Secondly, the absence of a central agency's involvement leaves no room for selective monitoring by the agency.[762]

However, the cost of litigation hinders effective monitoring because legal costs can be an obstacle for party harmed bringing the breach to the court.[763] In such cases, the monitoring system of private law does not function.[764] Also, monitoring in private law is only backward-looking, which means contravention of law can be detected only after the harm has taken place.[765]

Based on the above, it can be seen that there is also complementarity in monitoring between the two institutions. The limitations of private law monitoring due to its backward-looking nature and burdensome costs involved can be supplemented by the ex-ante and proactive monitoring of regulation. On the other hand, inadequate monitoring in some areas due to the regulator's selective monitoring and insufficient resources can be improved by the wider scope of individual private actors' monitoring in private law.[766]

6.1.3 Enforcement and intervention

Enforcement and intervention encompass a range of actions in the face of non-compliance with standards or emergence of potential risks.[767] The regulator has various coercive tools for enforcement: public censure, financial penalties, suspending permission, restitution

[761] Ibid
[762] Peter Cane (n 716) 317
[763] Peter Cane (n 716) 316; TT ARVIND and JOANNA GRAY (n 697) 13
[764] Matthew C Stephenson (n 750) 108
[765] Peter Cane (n 716) 316
[766] Allen M Linden, (n 735), 155, 156 and 158-159
[767] Peter Cane (n 716) 316

order or cancelling a permission.[768] The clearest advantage of regulatory enforcement is its proactivity.[769] There is no reliance on requests for enforcement from those directed affected by regulatory breach or other third parties in order to launch an investigation and initiate enforcement or intervention action – this is done at the regulator's discretion.[770] In deciding whether to take enforcement and intervention action, the regulator will weigh the cost against the merit of the action.[771] This is made possible by the regulator's sufficient expertise to understand the impact of enforcement or non-enforcement on the market.[772] Proactivity and the ability to take enforcement and intervention action at its discretion enable the regulator to use its resources efficiently in pursuing its objectives.

The key disadvantage of regulation with respect to enforcement and intervention is that the regulator can be vulnerable to external influences.[773] External influence can come from the regulated entities, political parties and other interest groups.[774] The regulator can be persuaded consciously or unconsciously by regulated entities to conduct under-enforcement.[775] Politicians may put pressure on the regulator, regarding politically important issues, to achieve the enforcement that they desire.[776] As the regulator is answerable to parliament, it cannot be free from the pressures of political parties.

[768] See Chapter III 3.3.2
[769] Pistor, Katharina, and Chenggang Xu, 'Incomplete law' (n723) 954
[770] Joseph A. Grundfest, 'Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority' (1994) 107 Harv. L. Rev 961, 970
[771] Andrei Shleifer, 'Understanding regulation'(n 730) 446
[772] Ibid
[773] Matthew C Stephenson (n 750) 110
[774] Ibid
[775] George J.Stigler, 'The Theory of Economic Regulation', 2 Bell J. Econ. & Mgmt. Sci.3 (1971) 10-13
[776] Matthew C Stephenson (n 750) 119

In private law, the court orders the wrongdoers to compensate those affected by the wrongdoing, which functions as the tool of enforcement.[777] The biggest advantage of private law enforcement is that the court's decision is more insulated from the influence of political parties and interest groups compared to the regulator.[778] This advantage is substantial in that actions against standard violators tend to involve political risks and so enforcers without the capability or willingness to bear the risks cannot take necessary actions.[779] Landes and Posner explained that even though there were many tools that 'political branches' could use to put pressure on the judiciary such as 'budget harassment', 'tinkering with the court's jurisdiction' and 'altering the composition of the judiciary', those tools were not exercised frequently because it could damage the perceived independence of the judiciary, which would result in the costs to beneficiaries of legislation.[780] In addition, the sharply contrasting interests between the plaintiff and the defendant[781] does not leave any space for another third party to intrude in the decision process of the court.[782]

However, the enforcement of private law has its disadvantages. First of all, the access to private law is restricted. In addition to the legal expenses involved,[783] the burden of proving in court that there was a violation of law and that there is a causal relationship

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[777] Peter Cane (n 716) 317; Steven D Shermer, 'Efficiency of Private Participation in Regulating and Enforcing the Federal Pollution Control Laws: A Model for Citizen Involvement' (1999) 14 J. Envtl. L. & Litig. 461, 477

[778] Richard A. Posner, *Economic Analysis of Law* (n 609) 385 ; Andrei Shleifer, 'Understanding regulation' (n 730) 444; J. Maria Glover (n 758) 1149

[779]Ana Carvajal, and A. Elliott Jennifer, *The Challenge of Enforcement in Securities Markets: Mission Impossible?* (No. 9-168. International Monetary Fund, 2009) 25

[780] William M. Landes & Richard A. Posner, 'The Independent Judiciary in an Interest-Group Perspective' (1975) 18 J. Law & Econ. 875, 885

[781] Weinrib, Ernest J. *The idea of private law* (OUP Oxford 2012) 76

[782] Andrew Robertson, 'Constraints on Policy-Based Reasoning in Private Law in Robertson' in Andrew, and Hang Wu Tang (eds), *The goals of private law* (Bloomsbury Publishing, 2009) 272

[783] See n657; Hugh Collins, *REGULATING CONTRACTS* (n 625) p87; Peter Cane (n 716) 316

between the violation and the detriment is also an obstacle which makes private law difficult to access.[784]

Enforcement and intervention is not an exception to the complementarities between the two institutions. The regulator's vulnerability to external influence can be supplemented by the court's comparatively strong insulation from outside pressure.[785] Myopic focus on individual cases without considering the externality of its ruling, which is a shortcoming in standard setting, is a strength of private law for independent enforcement. On the other hand, the difficulty of accessing private law enforcement can be supplemented by the proactive enforcement of regulation.

6.1.4 Implication

Private law and regulation are different institutions for controlling activities that have the risks of harming in society.[786] The strengths and weaknesses of the two institutions as a device of "deterrence" and "compensation" have been examined. As seen in the analysis of strengths and weaknesses above, one institution does not dominate and offer innate superiority over other in the achievement of their three sub-processes, i.e. standard setting, monitoring and enforcement and intervention. Each institution has its own disadvantages which can be complemented by the other.[787] This means that, structurally, there could be complementary interplay between private law and regulation to achieve social good more

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[784] Hugh Collins, *REGULATING CONTRACTS* (n 625) p89; Della Negra, Federico. 'The private enforcement of the MiFID conduct of business rules. An overview of the Italian and Spanish experiences' (2014) *European Review of Contract Law* 10.4, 571, 580
[785] J. Maria Glover (n 758) 1149
[786] Steven Shavell, 'Liability for harm versus regulation of safety' (No. w1218. National Bureau of Economic Research, 1983) 357
[787] Fabrizio Cafaggi (n 698) 196; Matthew C Stephenson (n 750) 107-112; J. Maria Glover (n 758) 1161-1185

effectively.[788] From the perspective of an 'instrumentalist', who believes that social institutions including private law should exist and be used as an 'instrument' for enhancing social welfare, the two institutions are well positioned to achieve this together.[789] Complementary interplay can be an efficient 'division of labour' between the two institutions, which enables the regulator to focus its limited resources on its comparatively advantageous areas.[790]

The attempt to coordinate private law and regulation in financial services law has continued from firstly the Section 62 of the FSA 1986 to recent Section 138D of the FSMA 2000, which provided a statutory "right of action" to some consumers for detriments arising from contravention of regulatory rules.[791] The next section will examine the current situation of the two institutions' interplay in financial product transactions.

6.2. Current situation

6.2.1 Standard setting

Both private law and regulation have the function of standard setting and they have their own standards applied in the cases of "mis-selling" of financial products including over-the-counter derivatives. But as it was seen in Chapter V, the standards of the two institutions diverge and sometimes conflict with each other. The dissonance associated with standards between the two institutions was mainly due to the difference in the functions that they undertake, which have resulted in different standards: private law's

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[788] Jonathan R. Hay and Andrei Shleifer, 'Private enforcement of public laws: A theory of legal reform' (1998) 88 American Economic Review 398, 400-401

[789] Djankov, Simeon, et al. 'The new comparative economics' (2003) 6-17 <http://escholarship.org/uc/item/9rn8c3tq#page-18> ; Alastair Hudson, 'The synthesis of public and private in finance law' (n572); Shavell, Steven. *Liability for harm versus regulation of safety* (No. w1218. National Bureau of Economic Research, 1983) 357

[790] Steven D Shermer (n 777) 469

[791] See n906

function of facilitating transactions in the market and regulation's function of remediating market failures.[792] Even though each institution standards have their own rationale, the divergence of the standards causes substantial legal uncertainty: a transaction of over-the-counter derivatives can be seen as a "mis-selling" under regulation but is not seen as a wrongdoing to be compensated under private law.[793]

Besides the uncertainty, the dissonance can prevent the market from creating a moral norm in the area of financial products transactions, by blurring "the right" and "the wrong". Moral norms are internalized in market participants' decision process and so are a very efficient way to maintain a desirable order with low costs.[794] More importantly, any social institution cannot successfully achieve its goals 'without being internalized by the citizens and without robust backing of social norms.'[795] The dissonance not only hinders the creation of a norm but can also create opportunistic attitude in market participants: financial institutions focusing on technical approaches to avoid legal or regulatory liability rather than making cultural or procedural improvements in its sales practice for better consumer protection[796]; consumers looking to more protective regulation when their financial products turn sour rather than taking responsibility for their investment decisions[797].

6.2.2 Monitoring

[792] See Chapter V 5.2.1
[793] See Chapter V 5.1.1
[794] Platteau, Jean-Philippe. 'Behind the market stage where real societies exist-part II: The role of moral norms' (1994) 30.4 The Journal of Development Studies 753, 802; Avner Greif, 'Contracting, enforcement and efficiency: Economics beyond the law' *in Annual World Bank Conference on Development Economics 1996* (The World Bank 1997) 242
[795] Anastassios D Karayiannis and Aristides N. Hatzis, 'Morality, social norms and the rule of law as transaction cost-saving devices: the case of ancient Athens' (2012) 33.3 European Journal of Law and Economics 621, 622
[796] Alastair Hudson, *The law of finance* (n 90) para 5.37-41
[797] Yane SVETIEV and Annetje OTTOW. 'Financial supervision in the interstices between public and private law' (2014) 10.4 European review of contract law 496, 511

6.2.2.1 Regulatory monitoring

The monitoring by regulation takes place both before and after the occurrence of breach and this is one of the advantages of regulation over private law.[798] The FCA, the current financial regulator, engages in both pre-emptive and reactive monitoring and intervention. The 'three pillars' of supervision that the FCA has announced to achieve its consumer protection objectives demonstrates well its approach to monitoring.[799] The three pillars which consist of 'firm systematic framework', 'event supervision' and 'issues and product supervision', involve both pre-emptive and reactive monitoring and intervention, and this section will examine the three pillars with a focus on monitoring activities.[800]

As a means of pre-emptive monitoring, the FCA periodically examines culture, governance, business processes and internal controls of financial institutions to ensure that they run their business in the interest of consumers ('firm systematic framework'), and conducts thematic reviews which analyse emerging risks in multiple firms or sectors ('issues and product supervision').[801] The 'firm systematic framework' involves a general assessment of financial institutions, covering areas such as business strategy, growth rate and profitability, and can lead to in-depth examination, if a risk is identified.[802] The 'firm systematic framework' is applied only to a small number of financial institutions selected based on the importance of their presence in the market.[803] If the risk identified through 'firm systematic framework' or other intelligence sources has the potential to be widespread in

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[798] See n756
[799] Financial Conduct Authority, 'The FCA's approach to advancing its objectives' (2013) 18-19
[800] Ibid
[801] Financial Conduct Authority, 'The FCA's Approach to Supervision for fixed portfolio firms' (2015) 11-12 and 15-22
[802] Ibid 15-19
[803] Ibid 9

other firms or sectors, the 'issues and product supervision' can commence thematic reviews over multiple firms or sectors.[804]

Periodic on-site review[805] is another example of 'firm systematic framework', and reviews[806] of a specific product and mystery shopping[807] are examples of 'issues and product supervision'. The objectives of 'firm systematic framework' and 'issues and product supervision' are pre-emptive monitoring focused on identifying risk factors before consumer detriments happen.

The FCA puts great emphasis on pre-emptive monitoring in that the regulator can detect potential risk in advance and can prevent consumer detriments.[808] However, pre-emptive monitoring cannot capture all the potential risks of consumer detriment[809] because the FCA just has too many financial institutions (about 26,000) to monitor[810] and doesn't have an omniscient ability to anticipate all possible detriment in the future[811]. This is why the FCA also employs what it describes as 'event supervision' as an ex-post or reactive monitoring method.[812] 'Event supervision' is a regulatory action after consumer detriment occurs and is focused on 'the most important issues' to the regulator's objectives of consumer protection.[813] The regulator's approach to event supervision is proportionate to the seriousness and significance of the issue.[814] The monitoring system of the FCA is

[804] Ibid 21-22
[805] Ibid 18
[806] Ibid 22
[807] Ibid
[808] Ibid 17, 20
[809] J. Maria Glover (n 758) 1148; See eg Yane SVETIEV and Annetje OTTOW (n 797) 508; European Securities and Markets Authority, *MiFID-Conduct of Business, fair, clear and not misleading information* (ESMA/2014/1485, 2014) para 23
[810] Financial Conduct Authority, 'The FCA's approach to advancing its objectives' (2013) 6
[811] J. Maria Glover (n 758) 1148
[812] Financial Conduct Authority, 'The FCA's Approach to Supervision for fixed portfolio firms' (2015) 15
[813] Ibid 20
[814] Ibid

designed not to address any individual complaints which are not "important" individually. Instead, it guides consumers to make complaints only to the sellers or the Financial Ombudsman Service.[815] For instance, in the case of interest rate hedge products which had significant social impact, many complaints reached the regulator through consumers' MPs and the media.[816]

In summary, the monitoring strategy of the FCA aims to identify the risks of consumer detriments as early as possible while using its regulatory resources efficiently. The balanced deployment of ex-ante and ex-post monitoring can be understood as an attempt to improve the efficiency of monitoring because the approach of trying to identify all risks beforehand is very costly. Its strategic focus of monitoring on 'big issues' is also for efficiency.[817] As described previously in the section 5.1.2, monitoring by a regulator is selective.[818] The FCA explains that the importance of the issue depends on the 'nature and size' of the problem.[819] Prioritizing the issues to focus on based on the nature and size is aligned with one of its regulatory principles, 'use its resources in the most efficient and economic way', which is stipulated by FSMA 2000.[820]

Another reason can be because the FCA is answerable to the parliament and so will naturally concentrate on the big issues which can make a political windstorm. The history of regulatory sanctions against the "mis-selling" of over-the-counter derivatives, which had large-scaled consumer detriments (or risks) related with up to hundreds of thousands of

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815 See 'How to complain' section in FCA homepage <http://www.fca.org.uk/consumers/complaints-and-compensation/how-to-complain>
816 Financial Supervisory Authority, 'FSA update: Interest rate hedging products-Information about our work and findings'0. (2012) 2
817 Financial Conduct Authority, 'The FCA's Approach to Supervision for fixed portfolio firms' (2015) 7 and 20; Financial Conduct Authority, 'FCA Our strategy' (2014) 6
818 See n758
819 Financial Conduct Authority, 'The FCA's Approach to Supervision for fixed portfolio firms' (2015) 20
820 FSMA 2000 s 3B(1)(a)

consumers, illustrates the regulator's strategy of focusing on big issues.[821] However, this efficient allocation of monitoring resources inevitably creates blind spots that regulatory monitoring does not reach. Consumer detriments where the 'nature and size' is not significant based on the criteria of the regulator can continuously be left outside of the regulator's monitoring radar.

However, suffered consumers who are undetected by the regulator's monitoring are not necessarily outside of the notice of the regulatory monitoring system. Eligible consumers can make complaints to the FOS for compensation for their detriments.[822] The FOS determines their claims based on 'fairness and reasonableness' and can order the financial institution concerned to compensate the consumer for the loss.[823] Regulatory rules are one of the most important criteria for the FOS to determine 'fairness and reasonableness'.[824] So, the FOS can be said to function as a part of the regulatory monitoring system. The FOS is a robust monitoring system for detecting consumer detriments in that the FOS is easily accessible by consumers because it is free of charge and its adjudication process is much quicker and less formal than the court.[825]

The limit of the FOS as a monitoring system is its narrow eligibility for complainants; natural persons or micro enterprises[826] with less than 10 employees and less than €2 million of turnover or balance sheet are the eligible complainants.[827] Another limit is that the amount of compensation awarded by the FOS cannot exceed £150,000.[828] Due to the limitation in

821 See n352
822 See n194
823 See n195
824 See n196
825 See n194; House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n333) 63
826 Financial Conduct Authority, FCA Handbook, Glossary, micro-enterprise <https://www.handbook.fca.org.uk/handbook/glossary/G2623.html>
827 FCA Handbook, DISP 2.7.1R, 2.7.3R
828 FCA Handbook, DISP 3.7.4R

eligibility and the amount of reward, the FOS cannot address all the consumer detriments not captured by the regulator.

The FCA acknowledged that businesses ineligible for bringing complaints to the FOS may represent a large portion of the SME sector's users of financial services[829]; 61% of SME bank loans outstanding at the end of 2014 was to businesses with turnover of over £2 million[830], which is outside the remit of the FOS. In particular, the IRHPs scandal brought to light the limited remit of the FOS. The Parliamentary Commission on Banking Standards ("PCBS") pointed out that many SMEs who suffered loss from IRHPs were found to be outside the remit of the FOS;[831] the PCBS referred to a report[832] which stated that, among the SMEs with the turnover size over the remit of the FOS, one third didn't have dedicated staff for financial management. The PCBS acknowledged that many SMEs excluded from the remit of the FOS didn't have the capability to proceed civil actions against banks even with valid cases and thus recommended the FCA to consider expanding the remit of the ombudsman.[833]

However, extending the remit of the FOS cannot entirely solve the problem of blind spots of regulatory monitoring. It is not possible to totally remove the limit of the remit of the FOS because it would lead to the disturbance of the entire legal system in financial services sector. In addition, as the PCBS acknowledged, too wider remit of the FOS would put much burden on the FOS.[834] Even with an extended remit of the FOS, there will inevitably

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[829] Financial Conduct Authority, 'Our approach to SMEs as users of financial service' (2015) 8 and 30

[830] British Bankers Association, 'Bank Support for SMEs – 4th Quarter 2014' (2015) https://www.bba.org.uk/news/statistics/smestatistics/bank-support-for-smes-4th-quarter-2014/ accessed on 1 November 2015

[831] House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n333) 65

[832] Ibid n316

[833] Ibid 65

[834] Ibid

be a group of individuals and SMEs which remain outside of the regulator's monitoring radar.

To sum up, the current system of regulatory monitoring of financial product transactions has significant loopholes in that some consumer detriments may go undetected both by the regulator due to its selective monitoring and by the FOS due to its limited eligibility.

6.2.2.2 Monitoring by private law

Now, does monitoring by private law complement the regulatory "failures" in its monitoring? In the cases of "mis-selling" of over-the-counter derivatives, the answer to this question is negative. In principle, any consumer who failed to receive compensation from regulation can bring his case to the court and monitoring of private law takes place through litigation raised by the consumers. But they will do it only when they expect that they are able to succeed in the litigation. As shown in Chapter IV, the prospect of litigation by those affected consumers is not attractive for them, considering the fact that only 1 consumer out of 13 consumers secured redress order from the court.[835]

As shown in Chapter IV, the court confirmed that corporate consumers other than natural persons, even micro enterprises, are not entitled to a statutory "right of action" for breach of regulatory duty,[836] and no consumers have succeeded in getting compensation in the litigation of "mis-selling" of over-the-counter derivatives based on common law principles.[837] Even some consumers who are private persons who have a statutory "right of action" by section 138D also failed to receive compensation in litigation due to the failure of establishing causal relationship between the breach of regulatory rules and the

[835] See Table 1 at 68
[836] See n436
[837] See Table 1 at 68

loss.[838] As a result, consumers' expectation of judiciary redress for their claims of "mis-selling" of over-the-counter derivatives can but be low, whether based on statutory rules or on common law. Under such legal circumstances, it is difficult to anticipate that consumers will bring their claims of "mis-selling" of over-the-counter derivatives to the court even with valid cases.[839] This means that the monitoring of private law does not play a complementary role to cover the blind spots of the regulatory radar.

6.2.3 Enforcement and intervention

6.2.3.1 Enforcement and intervention in regulation

The financial regulator is empowered to perform functions of deterrence and compensation to achieve the objective of consumer protection.[840] In the cases of "mis-selling" of over-the-counter derivatives, for the purpose of deterrence, the regulator has mainly used fines among many other coercive tools.[841] However, as already shown in Chapter III, the amount of fines is substantially short of the estimated commission profit earned by financial institutions through the penalized "mis-selling" of over-the-counter derivatives.[842] So it is questionable whether regulatory fines can sufficiently deter potential breaches.

In the domain of regulatory compensation, it is also difficult to say that compensation is made to all the deserving consumers. First of all, as the previous section explained, some consumer detriments which are not significant enough for regulator's intervention and are

[838] Ibid; see also n881
[839] See House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n333) para 173; see eg Liina Tulk, 'Interest rate swap litigation: strikeout for claimants following bank's victory', <http://mbmcommercial.co.uk/blogs/banking-disputes-blog/interest-rate-swap-litigation-strikeout-for-claimants-following-banks-victory/> accessed 15th March 2016
[840] See n 38
[841] See Table 1 at 68
[842] See n353

beyond the remit of the FOS cannot be detected by the regulatory monitoring system.[843] Also even those consumer detriments that have been detected by the regulator are not, it can be argued, all compensated fairly and transparently as the case below reflects.

The FCA has, in principle, a policy to allow financial institutions to voluntarily compensate for consumer detriments when there is a contravention of regulatory rules, instead of getting involved to 'carry out extensive follow-up work'.[844] In all sanctioned "mis-selling" cases of over-the-counter derivatives where losses occurred to consumers, the financial institutions awarded redress on a voluntary basis.[845] The regulator, in most cases, did not oversee the criteria and the process of determining eligibility for voluntary compensation employed by the financial institutions.[846] In addition, the criteria of voluntary compensation was not publicized. Only in the "mis-selling" case of IRHPs which was a big issue to the regulator, was it exceptionally involved directly in extensive follow-up work of checking and creating compensation criteria.[847]

As a result, the consumers who suffered loss could not judge or monitor whether they were compensated fairly. So it cannot be guaranteed that the voluntary redress by the violator provides all the aggrieved consumers with fair compensation. Of course, consumers who are not compensated or not satisfied with the voluntary compensation can make complaints to the FOS.[848] But again, such compensation is still only available to

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[843] See n821, n827, n828

[844] Financial Conduct Authority, 'The FCA's Approach to Supervision for fixed portfolio firms' (2015) 3; Christopher Hodges, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics* (Bloomsbury Publishing 2015) 279-285

[845] See n362

[846] See n363; Christopher Hodges, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics* (n 844) 279-285

[847] Financial Supervisory Authority, 'Letters to financial institutions related with IRHPs' (2013) <https://www.fca.org.uk/your-fca/documents/irhp-letter-january-2013> ; Financial Supervisory Authority, 'Interest Rate Hedging Products: Pilot Findings' (2013)

[848] See Financial Supervisory Authority, 'Interest Rate Hedging Products: Pilot Findings' (2013) 13

eligible consumers. The consumers who are not provided with voluntary compensation nor the FOS compensation are only left with the option to go to the court to seek redress.[849]

Another gap in regulatory compensation is its narrow scope. The compensation criteria for IRHPs, which the regulator co-created[850] with financial institutions, revealed the regulator's intended coverage of regulatory redress. The criteria allowed for the review of the sales process only for 'non-sophisticated' consumers and not for the 'sophisticated' consumers.[851] As a result, 10,596(34.3%) consumers could not qualify the 'sophistication test'[852] out of 30,804 consumers in IRHP's review.[853]

The scope of non-sophisticated consumers are much narrower than the scope of 'retail client'[854] which is the class of consumers under the most expansive protection by the COBS. This means that even if they are retail clients for the purposes of the COBS, if they could not meet the conditions of the sophistication test, they had no accessibility to regulatory compensation and had to rely on private law for redress because as non-sophisticated consumers they cannot qualify for eligibility of the FOS in that the sophistication test has tighter criteria than the FOS eligibility test[855]. For instance, a SME with £7 million of turn-over and £4 million of balance sheet is classified into a retail client in the COBS but not into a non-sophisticated consumer in IRHPs review process nor into an eligible consumer for the FOS. It can also be assumed that the regulator's intention to cover only non-

[849] See n878
[850] House of Commons Treasury Committee, 'Conduct and competition in SME lending' (2015) 40
[851] Financial Services Authority, 'Interest Rate Hedging Products: Pilot Findings' (2013) 13
[852] See n330
[853] Financial Conduct Authority, 'Aggregate position chart' (2015) <http://www.fca.org.uk/static/documents/aggregate-progress.pdf> accessed May 2016
[854] See n265
[855] See n330 and n337

sophisticated consumers for regulatory redress may be applied to financial institutions' voluntary compensation schemes in other cases as well because financial institutions would follow the regulator's intention if there is no specific reason.

The final aspect of the problem of regulatory compensation is the external influence on the regulator. As mentioned before, regulation in its enforcement may be vulnerable to external influence.[856] The IRHPs' compensation process well illustrated the financial regulator's exposure to pressure from politics and other interests groups. The Treasury Committee of the House of Commons collected consumers' complaints about regulatory compensation for loss from IRHPs, and publicly criticised the regulator's compensation criteria and process in detail including the sophistication test, the complainant's access to review information and the appeal process.[857] Consumers of IRHPs also formed an interest group for themselves, put pressure on politicians to take action for their interest and directly attacked the FCA's approach to IRHPs.[858] From the direction in favour for financial institutions, there was also suspicion in the media that the government dismissed the former CEO of the FCA due to his tough position against financial institutions in dealing with various issues including the IRHPs scandal.[859] With no exact explanation from the government about the reason of the former FCA CEO's sudden departure, it is not possible to verify the true cause but the fact that the Conservative, the ruling party at the time, received over 50% of its fund from the City in 2014 makes the above suspicion structurally

[856] See n773
[857] House of Commons Treasury Committee, 'Conduct and competition in SME lending' (2015) 34-65
[858] See http://bully-banks.co.uk/site/ accessed 15 May 2015
[859] See eg Lindsay Fortado et al, 'Martin Wheatley resigns as chief of Financial Conduct Authority', *Financial Times* (London, 15 July 2015) <http://www.ft.com/cms/s/0/61f867fa-2c76-11e5-8613-e7aedbb7bdb7.html#axzz3tMQBPsG4> accessed 1 April 2015; The City Grump, 'FCA CEO Martin Wheatley's removal could signal a new era in terms of investment', *realbusiness* (London 20 July 2015) <http://realbusiness.co.uk/article/30814-fca-ceo-martin-wheatleys-removal-could-signal-a-new-era-in-terms-of-investment> accessed 1 April 2015

"probable" [860], if not true. The fact that the regulator suddenly abandoned, just after the dismissal of the former CEO, its ambitious on-going project of reviewing the culture of the banking industry, which had been initiated under his leadership, gives more weight to the suspicion.[861] If the suspicion is true, this is a prime example of 'private interest theory' of regulation in the real world; the CEO could not secure his position because he didn't protect the interest of the politically powerful group.[862]

Through the discussion above, it can be seen that the level of sanctions by the regulator may not be enough for deterrence and that some suffered consumers are left outside of the safety net of regulatory compensation due to the voluntary and opaque compensation scheme and the regulator's narrow scope for redress. There was also an actual case that exposed the vulnerability of the regulator to pressure from outside. The following section will examine if private law complements such shortcomings and loopholes of regulation in its enforcement and intervention.

6.2.3.2 Private enforcement

Private law has two standards in dealing with claims of "mis-selling" of financial products: 1) common law standards that apply to consumers who are non-private persons such as corporates and 2) regulatory rules that apply to consumers who are private persons. This

[860] See Nicholas Watt and Jill Treanor, 'Revealed: 50% of Tory funds come from City', *the guardian* (8 February 2011) <http://www.theguardian.com/politics/2011/feb/08/tory-funds-half-city-banks-financial-sector> accessed 21th May 2016

[861] George Parker and Emma Dunkley, 'FCA denies being pressed by Treasury to drop banking review', *Financial Times* (11 January 2016) < http://www.ft.com/cms/s/0/44e0a70a-b88e-11e5-b151-8e15c9a029fb.html#axzz49HSrvvXc> accessed 21th May 2016

[862] See n678

dichotomous application of standards is the result of the FSMA 2000 which entitles only the 'private person'[863] with a "right of action" for breach of statutory duty.[864]

Firstly, it will be examine how consumers that are non-private persons, i.e. corporate consumers, who are not compensated by regulation are dealt with under private law in the claims of "mis-selling" of over-the-counter derivatives.

Corporate consumers which cannot pass the 'sophistication test' are excluded from regulatory compensation, as seen in the previous section.[865] Their cases, when brought to the court, are subject to common law and not bound by the regulatory rules. Chapter V evidenced that in the court rulings, rosy market forecast, failure to explain risk and failure to disclose fess, all of which are contraventions of 'fair, clear and not misleading' rule of the COBS, are not misrepresentations.[866] The court rulings also showed that financial institutions are not seen to have a duty of care as an advisor if the contractual terms disclaim provision of any advice and so what regulation would see as unsuitable advice based on a "de facto" advisory relationship is not a breach of a duty of care in common law[867].

The *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc* is one example of this.[868] The plaintiff, a limited company in real estate development business, bought IRHP from the bank and suffered a huge loss from it. There is no information available about why the plaintiff brought the case to the court while regulatory compensation was in process, but it can be assumed that it was not eligible for

[863] See n429
[864] FSMA 2000, s138D
[865] See n851
[866] See Chapter V 5.1.1.2
[867] See n523
[868] [2013] EWHC 3167; see n419

the compensation scheme. Although it seems that its loss from IRHP could have been compensated under the regulatory 'compensation criteria'[869], the court did not accept any claims of the claimant based on common law; the court ruled that the non-disclosure of the commission by the bank, which was seen as a breach of 'fair, clear and not misleading' rule of the COBS[870], was not a misrepresentation because it was an arm's length transaction and that the mismatching terms between the hedged loan and the hedging IRHP, which was seen as contravention of regulatory rules[871], was not breach of duty because the contract stated that assessing the risk of the IRHP was the responsibility of the claimant.[872]

Secondly, consumers who are private persons can still be excluded from regulatory compensation due to reasons such as large sized[873] investments and other unpublicized reasons, or can be unsatisfied with the result of "voluntary" compensation. Then they can bring their cases to the court and the regulatory rules are applicable to these cases in the court under the Section 138D of the FSMA 2000. However, the likelihood of securing redress for this category of consumers in the court is not so promising. The biggest obstacle for this category of consumers is to prove, in the court, the causal relationship between the financial institution's contravention of regulatory duties and their losses.[874] The regulatory compensation criteria also requires causation between contravention and loss but the requirements of causation in common law is much more "precise".[875] And

[869] See n553
[870] See n553
[871] See n413
[872] See n414; See [2013] EWHC 3167
[873] For example, the size of IRHP should be below 10 million for the sophistication test in the IRHP scandals; Financial Services Authority, 'Interest Rate Hedging Products Pilot Findings' (2013) 10
[874] Financial Services Authority, 'Joint Committee on the Draft Financial Services Bill Memorandum from the Financial Services Authority' (2011) 8, <www.fsa.gov.uk/pubs/other/pls.pdf> accessed 16 January 2016
[875] See Chapter V 5.1.3; Stephen D Sugarman (n 587) 141

common law imposes the burden of proving causation on the claimant.[876] For individual consumers, it is really difficult to prove that he would have acted differently "but for" the financial institutions' breach.[877]

The *Zaki & others v Credit Suisse (UK) Limited*[878] offers an example showing the limitation of the private law's role in defending the loophole of regulatory compensation for consumers who are private persons. The plaintiff, a wealthy businessman, suffered a huge loss from a structured capital at risk product ("SCARP") which was recommended by the bank and brought his case to the court. Coincidently, the regulator, on its periodic onsite review, found some regulatory breaches in the bank's SCARP business and sanctioned it.[879] The bank agreed with the regulator to voluntarily compensate consumers' losses caused by its breach.[880] The fact that the plaintiff continued the litigation, even after the voluntary compensation, showed that the plaintiff was not redressed by the bank's compensation scheme or not satisfied (again, detailed information is not available). Even though the court accepted the bank's breach of suitability rules of the COBS in transactions with the plaintiff, it denied the existence of a causal relationship between the breaches of regulation and the loss of the plaintiff, and so ruled no compensation.[881]

The discussion above reveals that private law did not succeed in providing redress, whether based on common law or regulatory rules, for aggrieved consumers who were not compensated by regulation due to reasons such as financial institutions' voluntary

[876] Simon James (n 103) 159; Olha O Cherednychenko, 'Financial Consumer Protection in the EU: Towards a Self-Sufficient European Contract Law for Consumer Financial Services?' (2014) 10.4 European Review of Contract Law 476, 492
[877] Olha O Cherednychenko 'Financial Consumer Protection in the EU: Towards a Self-Sufficient European Contract Law for Consumer Financial Services?' (n 876) 492
[878] [2011] EWHC 2422 (COMM); [2012] EWCA Civ 583
[879] See n325
[880] Financial Supervisory Authority, 'FINAL NOTICE to Credit Suisse (UK) Limited' (2011)
[881] See n456

compensation scheme, opaqueness of the compensation criteria and the narrow scope of consumers for the compensation. This also shows that private law cannot supplement the insufficient deterrence function of regulation. In essence, private law fails to make up for the loopholes of regulation in its enforcement and intervention to effectively achieve both deterrence and compensation to protect the interests of consumers to whom over-the-counter derivatives have been sold in circumstances of "mis-selling".

6.2.4. Summary

The previous sections has illustrated that the complementary interplay between private law and regulation has not been effective in dealing with "mis-selling" of over-the-counter derivatives. Julia Black described this lack of interplay in the financial services law as 'separate rooms' where the two institutions rarely interacted and lived 'in an uneasy coexistence'.[882]

The key causes of such ineffective complementarity are first, the difference in the standards of the two institutions[883] and second, the difficulty of proving causation,[884] in private law, between breach of regulatory duty and the consumer detriment. Recommendations of reform in order to address those causes and enable a more complete complementary interplay between the two institutions will be discussed in the following sections.

6.3 Recommendation

6.3.1 Harmonisation of standards of the two institutions

6.3.1.1 General direction

[882] Julia Black, 'Law and Regulation: The Case of Finance in Regulating Law' in Christine Parker, *Regulating Law* (OXFORD 2005) 43-49
[883] Ibid p45
[884] See n881; see also George Walker, Robert Purves, and Michael Blair QC (n 116) para 12.06

Harmonisation is not substituting private law with regulation or vice versa. The sources of the dissonance between regulation and private law as explained in the previous section were that both institutions have their own history of standard developments to achieve different functions and goals.[885] Complementary interplay should be pursued while preserving the framework of each institution.[886]

In order to ensure complementary interplay while acknowledging the merits of each institution, positioning regulation as the minimum requirement in private law is recommended. 'Regulation as the minimum requirement' means that private law will see a breach of regulatory duty as negligence per se but can also impose more requirements on financial institutions than what regulation requires.[887] However, it is noteworthy that even if a breach of regulatory rules is seen as negligence, it gives rise to a liability only when it satisfies the causation[888] between the negligence and the detriment. For instance, the breach of the statutory rule of maintaining promotion records,[889] which does not have any causal effects in terms of consumer detriments, should not result in imposing civil liability on the financial institution, apart from a regulatory sanction.

If set as the minimum requirement, regulation would become the 'baseline' of private law[890] but 'regulatory compliance defence',[891] which means that compliance with regulation will preclude any liability in private law, would not be admitted.[892] Positioning regulation as the minimum requirement in private law is persuasive in that the reason that regulation

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[885] See section 5.2.1
[886] See Steve Hedley, 'Looking Outwards or Looking Inward? Obligations Scholarship in the Early 21st Century' in Andrew, and Hang Wu Tang (eds), *The goals of private law* (Bloomsbury Publishing 2009)
[887] See Rose-Ackerman S, *Rethinking the progressive agenda* (Simon and Schuster 1993) 124
[888] See section 6.3.2
[889] COBS 4.11.1R (1)
[890] Ibid
[891] American Law Institute, *Enterprise Responsibility for Personal Injury* (1991) 87-89
[892] Peter Cane (n 716) 320-321

was devised in the first place was to alleviate the market failures which could not be solved by private law.[893]

Making regulation the minimum requirement in private law has substantial advantages. Firstly, private law can develop its own knowledge and experience incrementally on top of regulation and will be capable of solving regulatory failures due to obsolete regulation.[894] Even though the swiftness of response is one of regulation's strengths, some time lag is inevitable and sometimes rule makers are not even able to recognize the gaps that it leaves.[895] In this regulatory vacuum, private law can prevent unfair outcomes in disputes over "mis-selling" of financial products by adding its own requirements because it is more apt to make subtle changes in its ruling.[896] Private law also can solve not only the obsoleteness of regulation but also the limit of rigid ex-ant regulatory requirements. Regulation cannot expect all the possible wrongdoing beforehand, so unconditional application of regulatory rules might sometimes reach an unfair result.[897] For instance, by the information disclosure rule of the COBS[898], a financial institution which does not provide any personal risk warning to exceptionally vulnerable consumers such as very old retired people is not liable for any breach of regulatory requirements only if it gives a risk

[893] See n710; Fabrizio Cafaggi (n 698) 192-193
[894] Peter Cane (n 716) 322; see section 4.4.3.2; TT ARVIND and JOANNA GRAY, 'The Limits of Technocracy: Private Law's Future in the Regulatory State', p11
[895] Katharina Pistor and Chenggang Xu, 'Incomplete law' (2002) 35 NYUJ Int'l L. & Pol. 931, 955
[896] Olha O Cherednychenko, 'Contract Governance in the EU: Conceptualising the Relationship between Investor Protection Regulation and Private Law' (2015) 21.4 European Law Journal 500, 515; [896] Alastair Hudson, *Law of Finance* (n 90) para 1-78
[897] Olha O Cherednychenko, 'Public regulation, contract law, and the protection of the weaker party: some lessons from the field of financial services' 22.5 (2014) European Review of Private Law 663, 673
[898] COBS 2.2.1R(2)

warning in a tiny-printed standard form.[899] Private law can ameliorate the regulatory failure from the rigidity and homogeneity of regulatory requirements.

Secondly, it promotes interaction between the two institutions. It will lead the court to take a close look at how the regulator interprets and enforces regulatory rules[900] and to develop its own ways of integrating regulatory rules with traditional private law.[901] On the other hand, the regulator which concentrates on widespread detriment to a large group of consumers can learn from how the court takes into account 'idiosyncratic factors' and better apply regulatory rules to individual cases of low homogeneity.[902]

The key question is, then, how to ensure the positioning of regulation as the minimum requirement in private law. The court can refer to regulation when it deems appropriate when deciding liability, but leaving this to judicial discretion cannot ensure that the harmonized integration happens.[903] In practice, the court seems, in disputes of "mis-selling" of over-the-counter derivatives, to be reluctant to consider regulation in deciding liability.[904] For legal certainty and consistent complementary interplay, an express statutory provision stipulating regulation as the minimum requirement in private law is necessary.[905]

6.3.1.2 Implementation

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[899] Olha O Cherednychenko, 'Public regulation, contract law, and the protection of the weaker party: some lessons from the field of financial services' (n 897) 673

[900] Olha O Cherednychenko, 'Contract Governance in the EU: Conceptualising the Relationship between Investor Protection Regulation and Private Law' (n 896) 515

[901] TT Arvind and Jenny Steel, 'Legislation and the Shape of Tort Law' in Arvind TT, *TORT LAW AND THE LEGISLATURE* (2012) n63 in Chapter I

[902] Fabrizio Cafaggi (n 698) 242; See Alastair Hudson, 'The synthesis of public and private in finance law' (n572) 5.B.; TT ARVIND and JOANNA GRAY (n 697) n14

[903] Law Commission, *Fiduciary Duties and Regulatory Rules* (Law Com no. 236, 1995) para 1.10; Keith Stanton, 'Legislating for Economic Loss' in Arvind TT, *TORT LAW AND THE LEGISLATURE* (Bloomsbury Publishing, 2012) 269-284

[904]Law Commission, *Fiduciary Duties of investment Intermediaries Executive Summary* (Law Com no. 350, 2014) Para 1.60; Alastair Hudson, 'The synthesis of public and private in finance law' (n572)

[905] Law Commission, *Fiduciary Duties and Regulatory Rules* (Law Com no. 236, 1995) para 6.2; Keith Stanton, 'Legislating for Economic Loss' (n 903) 269-284

The general direction for ensuring more complementary interplay between private law and regulation is proposed in the previous section: an express legislative provision stipulating regulation as the minimum requirement in private law for the court to take it into account in its decisions. Section 138D of FSMA 2000 is an important statutory tool through which to realize this general direction. The following section will examine the origin, meaning and drawbacks of section 138D and then suggest a plan for its improvement.

Brief history of legislative framework for private enforcement of regulation

Section 138D of the FSMA 2000 is the current express provision which gives some consumers a "right of action" for breach of regulatory duty by financial institutions.[906] This provision has a long history starting from Section 62 of the FS Act 1986. Section 62 of FS Act was the first legislative attempt in financial services law to confer a "right of action" on consumers who suffered loss from contravention of regulatory rules.[907] It is noteworthy that Section 62 provided a "right of action" for all persons including companies if they suffered losses as a result of regulatory contraventions.[908] However, it was never put into force.[909] After six months of suspension, it was overridden by Section 62A which restricted the range of persons conferred on the "right of action" to the 'private investor' [910], a term defined by secondary legislation[911]. Section 62A of the FS Act descended to Section 150 and to the current Section 138D of FSMA 2000 without substantial modifications ('private investor' was changed to 'private person').

[906] FSMA s138D
[907] Department of Trade and Industry, *Defining the private investor: a consultative document* (1990) 4
[908] Ibid
[909] Ibid
[910] Ibid
[911] The Financial Services Act 1986 (Restriction of Right of Action) Regulations 1991, SI 1991 No 486

The reasons that the government (Department of Trade and Industry) revised Section 62 with Section 62A were twofold. First, it was concerned that Section 62 would entail vexatious law suits in the financial services sector.[912] Especially, it sympathized with large financial institutions who were concerned[913] that Section 62 would be misused to initiate 'strategic' lawsuits by competitors.[914] Secondly, it alleged that Section 62 would lead the rule-makers, who were statutory regulator and self-regulatory organizations at that time, to making the rulebooks too descriptive and detailed for making it precise for lawsuits, which would result in rulebooks too complex to understand, too costly to comply with and too rigid and descriptive to improve the actual level of consumer protection.[915]

In spite of the drastic reduction of its ambit, Section 62A has some important meanings. It was the first provision in force, which tried to utilize private enforcement for public regulation in financial services law. This was a progressive step towards better interplay between private law and regulation. It created the legislative foundation to enable regulation to function as the minimum requirement in private law, because the claimant could receive compensation at least based on breach of regulation and the court could add additional requirements beyond regulatory rules[916].

Also, it secured the flexibility[917] of the ambit of its application by delegating the power of defining the range of persons entitled to employ this "right of action" to secondary legislation to be promulgated by the government[918]; so thereafter, the government has

[912] Department of Trade Industry, *Defining the Private Investor* (1990) 4
[913] Ibid
[914] Ibid
[915] Ibid, 5
[916] Peter Cane (n 716) 321
[917] Mattew C.Stephenson, 'Public regulation of private enforcement: The case for expanding the role of administrative agencies' [2005] Virginia Law Review 93, 121-123
[918] FSMA 138D (6)

been able to modify the range of consumers conferred on a "right of action" in line with the changes in financial environments.

On the other hand, Section 62A has set its limits by providing a "right of action" to only a section of consumers. Because of this, it has not only constrained complementary interplay but also entrenched the dissonance between private law and regulation. *Grant Estates Limited v The Royal Bank of Scotland*[919] shows the "side" effect of the provision restricting a "right of action" to only some consumers:

> More widely, I do not think that GEL [Grant Estates Ltd.] can rely on the COBS rules to create a common law duty of care in relation to the provision of advice. *A common law duty can arise from the existence of a statutory duty as part of the background circumstances; and the existence of a statutory duty may show that a particular risk should have been foreseen.* When the court assesses the effect of the statutory duty on the question whether it is just and equitable to impose a duty of care the primary consideration is, in my view, the policy of the statute. Looking to the policy of the FSMA one discovers that it provides protection to consumers of financial services through a self-contained regulatory code and statutory remedies for breach of its rules. As I have said, it needs no fortification by the parallel creation of common law duties and remedies. Further, *the existence of a duty in negligence for failure to comply with the COBS rules would circumvent the statutory restriction on the direct right of action* which I discussed in paragraphs [31]-[60] above... To my mind that approach is applicable also where Parliament imposes statutory duties on private bodies and individuals.[920] [emphasis added]

The provision giving a "right of action" only to private persons is interpreted by the court that regulatory rules should not be applied to non-private persons in private law, but this was not the intention of Section 62A. Department of Trade and Industry stated that 'Breach of statutory provisions always raises possibility of a "right of action", and s62 did not

[919] [2012] CSOH 133; see also Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc [2014] EWHC 3043 (Ch) [146]
[920] [2012] CSOH 133 [79]

therefore necessarily create a new right'.[921] Section 62A intended to express clearly that some consumers had a "right of action" but not to disclaim the general right of action for regulatory breach that the other consumers held in private law.[922] However, the legislative provision with the purpose of confirming a "right of action" of private persons prevents private law from adopting the concepts of regulatory duty as one of its standards in other groups of consumers.

Expanding the ambit of s138D of FSMA

For complete harmonization of private law and regulation, the key component needed is to expand the entitlement of the "right of action" in Section 138D. During the period of over two decades since the promulgation of Section 62A (later s150 and s138D), the "right of action" has been rarely used by the eligible persons.[923] This is because the "right of action" was granted only to a small group of consumers who are the least likely to bring claims to the court. 'Private persons' who usually have limited resources to proceed with litigation are entitled with the "right of action" by section 138D.[924] In addition, because individuals are able to get compensation through the FOS without litigation, if their reward is not beyond the limit of the FOS, the "right of action" is not much meaningful for them.

On the other hand, companies which are relatively better resourced for litigation and are excluded from the protection of the FOS[925] cannot avail themselves of the "right of action"

[921] The Financial Services Act 1986 (Restriction of Right of Action) Regulations 1991, SI 1991 No 486, para 2.1
[922] The Financial Services Act 1986 (Restriction of Right of Action) Regulations 1991, SI 1991 No 486, para 2.1
[923] See n41; Iain G. Macneil, 'FSA 1986: does s.62 provide an effective remedy for breaches of Conduct of Business Rules?' (1994) 15(6) Comp.Law. 172, n2; Financial Services Authority, 'Conduct of Business Sourcebook: Feedback on consultation and 'final text' and consultation on supplementary rules' (FSA, 2001) para 3.47
[924] Julian Pritchard, 'Investor protection sacrificed: the new settlement and s.62: part2' (1992) 13(11) Comp.Law. 210; Iain G. Macneil, 'FSA 1986: does s.62 provide an effective remedy for breaches of Conduct of Business Rules?' (1994) 15(6) Comp.Law. 172
[925] See n337

for breach of regulatory duty. This limitation of section 138D was shown in the recent IRHPs scandals; SMEs and micro-businesses, which were excluded from regulatory compensation including FOS rewards and so pursued lawsuits for loss from IRHPs, could not use the "right of action" by Section 138D in the court but had to depend only on private law principles such as misrepresentation.[926]

In fact, at the time of promulgation of Section 62A, many commentators were against the restriction.[927] The rationale for the restricted entitlement of the statutory "right of action" is not persuasive at least for now. It is argued that the concerns expressed about the risk of vexatious law suits was groundless in that conferring on the "right of action" from regulatory breach would not increase the risk of excessive litigation because, as the Department of Trade and Industry acknowledged, breach of statutory rules always 'had the possibilities to raise a "right of action"' in private law;[928] this means anybody without the statutory "right of action" can still bring the "vexatious" law suits to the court.

Actually, the cases where 'private persons' (or 'private investors') used the "right of action" are very rare[929] and limited only to very wealthy individuals. In the area of over-the-counter derivatives, only 3 consumers out of 15 consumers[930], whose investment size was

[926] See Table 2 at 107
[927] Joanna Gray, 'Financial Services Act 1986 reforms: Part2' (1991) 9(9) Int.Bank.L 412; Eva Z. Lomnicka, 'Curtailing section 62 actionability' [1991] J.B.L. 353; Iain G. Macneil, 'FSA 1986: does s.62 provide an effective remedy for breaches of Conduct of Business Rules?' (1994) 15(6) Comp.Law. 172; Julian Pritchard, 'Investor protection sacrificed: the new settlement and s.62: part2' (1992) 13(11) Comp.Law. 210
[928] Department of Trade Industry, *Defining the Private Investor* (1990) 3
[929] Iain G. Macneil, 'FSA 1986: does s.62 provide an effective remedy for breaches of Conduct of Business Rules?' (1994) 15(6) Comp.Law. 172, n2
[930] See Table 2 at 107

beyond dozens of million pounds, used the "right of action" as private persons.[931] This shows empirically that the range of the "right of action" is set too narrowly to be employed.

It was especially disproportionate to exclude all kinds of companies from the statutory "right of action" just for the purpose of preventing strategic lawsuits by competitors in the financial services sector.[932] The worries[933] voiced at the time about an overly descriptive rulebook is also not relevant anymore because rule books are made at the EU level under 'maximum harmonization'[934] or the single rulebook model.

Now there appears to be no definite reasons to hesitate to entitle all consumers with the "right of action" from contravention of regulatory rules. To prevent 'strategic'[935] lawsuits between competitors in financial services industry, it is enough to exclude financial institutions from the "right of action". This modification does not need the consent of parliament because the power of defining the 'private person' who has the "right of action" is delegated to the government.[936] Swift modification of the ambit of a "right of action" in line with the change of the financial environment follows the purpose for which the statute delegated such power.[937]

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[931] *Morgan Stanley UK Group v Puglisi Cosentino* [1998] C.L.C. 481; *Zaki & others v Credit Suisse (UK) Limited* [2011] EWHC 2422 (COMM); [2012] EWCA Civ 583; *Basma Al Sulaiman v Credit Suisse Securities* (Europe) *Limited, Plurimi Capital LLP* [2013] EWHC 400 (Comm)

[932] Julian Pritchard, 'Investor protection sacrificed: the new settlement and s.62: part2' (1992) 13(11) Comp.Law. 210

[933] See n915

[934] Niamh Moloney, *EU Securities and Financial Markets Regulation* (Oxford University Press 2014) n167; Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (n 81) 14

[935] See n914

[936] FSMA 2000, s 138D (6)

[937] Secretary of State of the DTI , 'HL Deb 16 Jan vol 503 c17', <http://hansard.millbanksystems.com/lords/1989/jan/16/companies-bill-hl> accessed 20 June 2016; See Mattew C.Stephenson (n 917) 121-139

As an added point, the COBS, which was created after a long period of consultation and research at EU and the national level,[938] already categorized consumers into three groups based on their experience and knowledge, and it differentiated the applicability of its rules for each group of consumers.[939] So the FSMA 2000 does not need to make another consumer classification criteria different from the one of the COBS. This makes, as the Department of Trade and Industry acknowledged,[940] 'unnecessary variations' in client classifications. Expanding the ambit of the "right of action" to all consumer types except for financial institutions can remove the confusion in consumer categorization in financial law, and promote complementary interplay between the two institutions.

6.3.2 Relaxed causation test

Section 138D of the FSMA 2000 stipulates that a private person has a "right of action" when he suffers loss 'as a result of' contravention of regulatory rules.[941] The phrase of 'as a result' requires the claimant to prove the causality between financial institutions' breach of regulatory rules and his loss.[942] The court confirmed that the ordinary causation test in common law, which requires the claimant to prove that his loss would not have occurred "but for" the breach (factual causation) and that his loss was not "remote" from the breach (legal causation),[943] should be applied in interpreting the phrase of 'as a result'.[944]

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938 Hugh Collins, 'The hybrid quality of European private law' (n 258) 457
939 FCA Handbook, COBS 3.4, 3.5, 3.6; Directive of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC, Article 4
940 Department of Trade Industry, *Defining the Private Investor* (1990) 8
941 FSMA 2000, s138D
942 Sandy Steel (n 451) 1; Kirsty Horsey and Erika Rackley (n 401) 222
943 McMeel, Gerard, and John Virgo (n 399) para 23.177 and 23.188
944 *Adrian Rubenstein v HSBC* [2012] EWCA Civ 1184; George Walker, Robert Purves and Michael Blair (n 116) para 7-30

However, it is difficult for consumers to prove causation. In terms of factual causation, the consumer should prove that he would have acted differently if the financial institution had not contravened regulatory rules.[945] For instance, for the ordinary causation test, a consumer should show that he would not have entered into the over-the-counter derivatives contracts if the financial institution had provided suitable advice or fair communication. This is quite difficult for consumers; the difficulty comes from the fact that much of the advice and information regarding investment is mainly delivered orally by representatives of financial institutions and so there is lack of hard evidence.[946] Also, behavioural science shows that consumers cannot tell why they behaved in a particular way because there were so many factors affecting their behaviour.[947]

In regard to legal causation, the affected consumer should establish that the regulatory breach by the financial institution is the "real" cause of his detriment among possible plural causes.[948] The cases of "mis-selling" of over-the-counter derivatives usually show that unexpected market turmoil reveals regulatory breach such as unsuitable advice or unfair communication.[949] Without the market turmoil, the detriment of the consumer might not have occurred and the regulatory breach might not have been known by anybody including the consumer. It is difficult even for the judge to decide on the real cause of the consumer detriment between market turmoil and regulatory breach.[950] The multiplicity

[945] Norbert Reich, 'The interrelationship between rights and duties in EU law' [2010] Yearbook of European Law 112, 158; Olha O Cherednychenko 'Financial Consumer Protection in the EU: Towards a Self-Sufficient European Contract Law for Consumer Financial Services?' (n 876) 492
[946] Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (n 81) 292
[947] R Incardona and C Poncibò, 'The average consumer, the unfair commercial practices Directive, and the cognitive revolution' (2007) 30(1) *Journal of Consumer Policy* 21, 21; The Law Commission and the Scottish Law Commission (n 395) 137
[948] See n454
[949] See p105
[950] See n461

of possible causes makes the proving of causation more difficult for consumers because the burden of proof of causation is on the claimant.[951]

In fact, pursuing "precise" causation might be the same as chasing a mirage because, as Laleng contended, the conclusion of causation must be 'interpretative' and 'probabilistic' intrinsically.[952] He, thus, argued that 'there is no such thing as objective causation in law'.[953] Practically, the FSA pointed out that it was constrained in its capability to compensate consumers due to the strict causation test of general law.[954] Porta and others also showed in their empirical research that a burden of proof of causation on consumers in civil law had a strong negative correlation with the development of the capital market.[955]

For the reasons discussed above, some commentators contend that the burden of proof of causation in the financial services sector should shift to the defendant once the claimant proves the defendant's regulatory contravention.[956] But caution is necessary in reversing the burden of proof of causation on to the defendant because it isn't consistent with the 'compensatory aim of private rights'.[957]

The 'Consumer Protection (Amendment) Regulations 2014' ("CPR 2014")[958] provides a good model of how the strict causation test can be modified when a "right of action" for

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[951] Ibid

[952] P Laleng (n 585) n5; see also Donal Nolan, 'Causation and the goals of tort law' in Robertson, Andrew, and Hang Wu Tang (eds) *The goals of private law* (Bloomsbury Publishing 2009) 167; The Law Commission and the Scottish Law Commission (n 395) para 8.4-8.5

[953] Ibid

[954] Financial Services Authority, 'Written evidence in Joint Committee on the Draft Financial Services Bill Evidence' (2011) 583 <http://www.parliament.uk/documents/joint-committees/Draft-Financial-Services-Bill/WEBWRITTENEVIDENCE.pdf> accessed 2 July 2016

[955] Porta, Rafael, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'What works in securities laws?' (2006) 61.1 The Journal of Finance 1, 19

[956] See eg Norbert Reich (n 945) 158

[957] The Law Commission and the Scottish Law Commission, *Consumer Redress for Misleading and Aggressive Practice* (LAW COM No 332, SCOT LAW COM No226, 2012) para 7.108; See also Sandy Steel (n 451) 121-136

[958] The Consumer Protection (Amendment) Regulations 2014, 2014 No.870

regulatory breach brings a case to the court. CPR 2014 confers on consumers a "right of action"[959] from regulatory breach and requires consumers to prove that the regulatory breach is 'a significant factor' [960] for their purchase of the products or services. It statutorily relaxes causation test from the "but for" to the "significance" test.

The relaxed causation test was recommended by the Law Commission in its report 'Consumer Redress for Misleading and Aggressive Practices' in 2012.[961] It concluded that it was unrealistic to require consumers to prove that they would not have entered into the contracts "but for" the sellers' breach,[962] but at the same time, it also objected to reversing burden of proof for causation to the sellers because this was against fair allocation of duties and rights[963]. As a solution, it suggested the 'significance' test which required consumers to prove that the sellers' breach affected their purchase decision "significantly".[964]

However, the Law Commission excluded financial services from the ambit of CPR 2014, explaining that the financial services sector already had sophisticated regulation and a generous compensation system of the FOS.[965] Its explanation of the financial services industry having an elaborate regulatory system is right but this cannot be the rationale for the financial services sector being subject to a different causation test from that of the other consumer industries. The financial services sector, as shown in the section 6.2[966],

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959 Ibid s27A.(1)
960 Ibid s27A.(6) which stipulates 'The third condition is that the prohibited practice is a significant factor in the consumer's decision to enter into the contract or make the payment.'
961 The Law Commission and the Scottish Law Commission, *Consumer Redress for Misleading and Aggressive Practice* (n 957) para 7.116
962 Ibid para 7.108
963 Ibid
964 Ibid para 7.116
965 Ibid para 6.107-118
966 See p170 and p178

also has the same problem of insufficient regulatory enforcement as the Commission identified as the case in other consumer industries[967]. Protection provided by the FOS is also limited in terms of the subject and the amount of the reward and so a substantial number of consumers, especially SMEs, should rely only on private law to be compensated.[968] Therefore there seems to be no coherent reasons to treat the financial services industry differently from the other consumer industries in terms of the causation test.

Some may express concerns that the eased causation test in the financial services sector, where unexpected market movements incurring losses to consumers, will entice them to bring meritless litigation for compensation of their losses. However, it should be remembered that the burden of proof of regulatory breach is still on the consumer and evidencing the regulatory breach of financial institutions during pre-contractual communication which usually is done orally is not easy for consumers. *Zaki & others v Credit Suisse (UK) Limited*[969] illustrates well how difficult it is for a consumer to establish regulatory breach of financial institutions. The claimant needed considerable forensic efforts to be able to demonstrate regulatory breach of the financial institution during the sales process, which was possible because he was a very affluent businessman,[970] but even in his case, most of his claims about regulatory breach such as provision of unsuitable advice were rejected by the court[971]. Considering the difficulty of evidencing regulatory

[967] The Law Commission and the Scottish Law Commission, *Consumer Redress for Misleading and Aggressive Practice* (n 957) para 1.7
[968] See n826, n827 and n828
[969] *Zaki & others v Credit Suisse (UK) Limited* [2011] EWHC 2422 (COMM)
[970] Ibid [2], [103]
[971] See p98

breach of financial institution in the court, it appears an unreasonable concern that relaxed causation test will increase meritless litigation by consumers.

In summary, relaxed causation test is needed to better enable the complementary role of private enforcement of regulation. For consistent implementation, the relaxed causation test of "significance" should be clearly expressed by amending section 138D of FSMA 2000.

Conclusion

This Chapter analysed the strengths and weaknesses of private law and regulation as a "regulatory system" about each process of standard setting, monitoring and enforcement and intervention, and in doing so, found that the two institutions have a potential to complement each other by making up for the weaknesses of the other. Regulation can supplement such weaknesses of private law as uncertainty of requirements, lack of risk-benefit analysis, back-ward looking and passive monitoring and heavy burdens on consumers for enforcement. At the same time, private law can cover such shortcomings of regulation as insufficient "monitoring and enforcement" and regulator's vulnerability to external influence.

This Chapter, then, examined how the two institutions with the potential for a complementary relationship interact with in the financial services sector. However, the result demonstrated that the two institutions do not have such interplay. They focus on "regulating" their own territory without interacting each other. The attitude of regulation towards private law seems to be "avoidance". The regulator has tried to use "voluntary" compensation schemes rather than official and legal apparatus such as restitution request or order. For the regulator, the solution through the court is the last option. The comment by the chairman of the FCA shows this attitude:

> Either we go through the law courts, which takes a very great length of time and costs a very great deal of money, or, as a proactive regulator, we go out on the front foot and say, "This is how we are going to do it", and the necessary part of "this is how we are going to do it" is coming to an arrangement with the banks that is "voluntary", or at least contractually voluntary, to do it that way. If they refuse, we end up in the law court...[972]

Julia Black described this attitude of regulation as recognizing 'law as risk'.[973] She explained that the perception of 'law as risk' illustrates that for market participants, including the regulator, 'law is uncertain, unpredictable and external' and this is because the market practice 'have outpaced the common law'.[974]

On the other side, the attitude of private law towards regulation can be summarized as "ignorance". The court sticks to the general principles of common law rather than adopting regulatory concepts as one of its standards. Cases in private law show that regulatory rules cannot override established principles of private law. The statute which provides partial entitlement of a "right of action" from breach of regulatory duty contributes to the court's "ignorance" of regulation. The "right of action" conferred on a small section of consumers hinders the regulatory standards to be absorbed by private law. The partial entitlement of the "right of action" is hampering the court's ability to apply regulatory standards to other consumer groups, which private law could have otherwise done to integrate regulatory requirements with its own principles. As a result, the statutory provision made with the purpose of using private enforcement of regulation paradoxically actually hinders it.

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972 House of Commons Treasury Committee (n 358) 37
973 Julia Black, 'Law and Regulation: The Case of Finance' (n 367) 52-54
974 Ibid 54; see also TT ARVIND and JOANNA GRAY (n 697) 2 and 14

This Chapter also pointed out the causation test of private law as one of the reasons preventing the interplay between the two institutions. Under the causation test of private law, successful private enforcement of regulation cannot be expected even when regulation is adopted as the one of standards of private law.

This Chapter recommended two specific legal reforms to enhance complementary interplay in order to address the recognized problems, i.e. dissonance of standards between the two institutions and over-burdening causation test of private law. The Chapter recommended the expansion of the "right of action" provided by the Section 138D of FSMA 2000 to all consumers except for financial institutions. The second recommendation was to relax the causation test in the case brought by the statutory "right of action" into a "significance" test in financial services law.

VII. CONCLUSION

7.1 Discussion of the thesis

The thesis has explored three research questions in relation to regulating "mis-selling" of over-the-counter derivatives. The first question was why transactions of over-the-counter derivatives, in particular, are prone to "mis-selling" practices. To answer this question, the thesis has analysed the products, participants and sales practice in over-the-counter derivatives markets. It has also shown that over-the-counter markets for derivatives are essential for fully utilizing the benefits of derivatives because of their inherent flexibility and capacity to meet specific needs of consumers.[975]

The results of the above analysis showed that over-the-counter derivatives markets are characterized by dependence of consumers on financial institutions during both the pre-contractual and contractual stages of transactions.[976] Asymmetric information and knowledge between consumers and sellers is the main cause of this dependence.[977] Consumers who are not familiar with derivatives products have no other choice but to rely on financial institutions to obtain the necessary information and knowledge about the over-the-counter derivatives products entered into which are usually designed by the financial institutions themselves.

The second characteristics of over-the-counter derivatives markets is the high profitability for sellers of over-the-counter derivatives.[978] Financial institutions can earn lucrative profits while avoiding market risks from transactions in over-the-counter derivatives thanks to

[975] See n37
[976] See p17
[977] See Chapter II 2.2.3.1
[978] See p19

sophisticated risk management techniques. The attractive financial incentives for sales representatives of financial institutions can lead them to sell over-the-counter derivatives to consumers regardless of the needs of consumers. The over-the-counter derivatives market can be said to be vulnerable to "mis-selling" because of consumers' dependence on sellers and the substantial conflicts of interest between consumers and sellers.

Use of over-the-counter derivatives is no longer the sole preserve of financial institutions or large corporations.[979] As observed in the recent interest rate hedging products scandal and other sanctioned cases in relation to structured capital at risk products, many SMEs and individual persons have entered into over-the-counter derivatives contracts.[980] On the supply side, advancing risk management techniques of financial institutions and handsome profit from over-the-counter derivatives transactions and on the demand side, more demand for tailored hedging and investment strategies, are resulting in the introduction of new products and new consumers into the over-the-counter derivatives market and driving its expansion.

Such characteristics of the over-the-counter derivatives market make it prone to "mis-selling" and as the market expands, this risk has assumed greater significance. Recognising this is the first step to addressing such risk and illustrates the need for research about how to better regulate "mis-selling" of over-the-counter derivatives.

The second research question was how financial regulation and private law have dealt with "mis-selling" of over-the-counter derivatives. A close look at standards and enforcement

[979] Carolyn H Jackson (n 22)

[980] Financial Services Authority, 'Interest Rate Hedging Products Pilot Findings' (2013); see Table1 at 68

cases of each social institution has revealed the dissonance in their approach to "mis-selling" of over-the-counter derivatives.

Financial regulation has evolved in the modern era, from the Prevention of Fraud Investment Act to the Financial Services Act 1986 to the Financial Services and Markets Act 2000, in its response to changing financial environments and regulatory failures.[981] This evolutionary process has taken place through regulation moving from "duty to disclosure" to "duty to protect consumers from their own behaviour".[982] Behavioural science has also provided theoretical back-up to the development of regulation towards paternalistic protection for consumers.[983] As a result, the current conduct of business rules require financial institutions to have fiduciary duties that include fully understanding their consumers' financial objectives and capabilities and recommending only suitable products, and communicating fairly in a not mis-leading way with consumers.[984] So in over-the-counter derivatives transactions, financial institutions should recommend products suitable for the consumer's objectives, capability and knowledge and experience and should inform the consumers of features of the over-the-counter derivatives including material risks and related commission.

The thesis has analysed how private law has dealt with claims of "mis-selling" of over-the-counter derivatives by taking a look at relevant litigation. It showed that contractually defined rights and duties between contracting parties of over-the-counter derivatives transactions constitute the main criteria in resolving "mis-selling" disputes in litigation.[985]

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[981] See Chapter III 3.1.1; Niamh Moloney, 'Financial services and markets' in Baldwin, Robert, Martin Cave, and Martin Lodge, *The Oxford handbook of regulation* (Oxford University Press 2010) 437
[982] See n267
[983] See Chapter III 3.1.2.3
[984] FCA handbook, COBS 4.2, 9.2 and 9.3
[985] See Chapter IV 4.2 and 4.3

As standard forms that financial institutions commonly use for over-the-counter derivatives transactions contain such clauses disclaiming that no advisory service is provided and that no representation is made, financial institutions can avoid the onerous obligation of an advisor and assume the duties of an equal counterparty in an arm's length contract.[986] In the cases of claiming "mis-selling" of over-the-counter derivatives, none of the consumers' claims of negligent advice and misrepresentation by financial institutions were accepted.[987]

Analysis of standards of financial regulation and of private law in the context of "mis-selling" of over-the-counter derivatives has revealed that the two institutions have different requirements on the same activities performed by financial institutions. Financial regulation demands that financial institutions assume fiduciary duties which cannot be denied or modified by contracts while private law sees an over-the-counter derivative transaction between a consumer and a financial institution as just another commercial contract between equal counterparties and so enforces the contractual terms which commonly include clauses disclaiming liabilities of financial institutions.[988] For instance, regulation imposes on financial institutions the duties to make suitable recommendations and to have clear and fair communication of information with consumers regardless of contractual terms, whereas private law usually does not acknowledge that financial institutions have duties as an advisor based on contractual relationship and only require they not state false facts in communication.[989]

Another dissonance between the two institutions in dealing with "mis-selling" of over-the-counter derivatives is the causation test. When ordering compensation, the two institutions,

[986] See n732
[987] See Table 2 at 107
[988] See Chapter V 5.1.2.2
[989] See Chapter V 5.1.1

both consider causal connection between wrongdoing and detriment as a necessary condition for compensation order. However, the approaches to causation taken by the two institutions are quite different.[990] The court makes substantial efforts to investigate the causation in the specific circumstances of each individual case. The court does not acknowledge causality without being doubtlessly convinced by the claimant that breach of duties by the financial institution is the real cause of the detriment of the consumers.[991] The court can be said to pursue "precise" causality. On the other hand, the regulator does not require a precise causal relationship between breach of financial institutions and detriment of consumers for compensation order.[992] The regulator does not demand the consumer to prove causation but considers its own reasoning about causality while pursuing a "fair" result.

The thesis then explained that the dissonance of standards between the two institutions on over-the-counter derivatives transactions originates from different functions undertaken by them. The major role of private law is to facilitate contracting activities between parties under the belief that transactions between individuals will increase their welfare and thus social welfare as well.[993] For this facilitative function, private law's main concern is to reduce transaction costs for negotiating, formulating and enforcing contracts while minimizing the law's intervention in contracting.[994] Overarching principles in private law such as freedom of contract and caveat emptor can be explained as enhancing efficiency of contracting.[995]

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[990] See Chapter V 5.1.3
[991] See Chapter IV 4.5
[992] See Chapter V 5.1.3.2
[993] See Chapter V 5.2.1.1
[994] See n616
[995] See n617

In the real world, however, the market system which is constituted largely through contracting of activities has shown some failures which cannot be solved on its own. Asymmetric information between consumers and financial institutions and consumers' bounded rationality are failures identified in the financial services sector, which the market system on its own cannot solve.[996] Financial regulation for consumer protection has emerged to correct those market failures. Therefore, financial regulation does not put much weight on private law's principles such as freedom of contract and caveat emptor because those principles cannot correct market failures such as informational asymmetry and bounded rationality.[997] In order to correct those market failures, conduct of business rules has evolved to impose fiduciary duties on financial institutions regardless of contractual relationship.[998] The dissonance between the two institutions is being made more and more clear as the role of regulation has expanded into the 'law jobs'[999] to such a level where it defines the rights and duties between contracting parties, resolves disputes and even order compensation.[1000] As a result, in the financial services sector, there are two different standards applied to regulating the same activities with the same purpose of deterrence and redress.

The third research question that the thesis has addressed is how to achieve harmonized interplay between the two institutions with different standards in regulating "mis-selling" of over-the-counter derivatives. Before answering this question, it was shown that the two institutions have the potential for complementarity and can supplement the weaknesses

[996] See Chapter V 5.2.1.2 (1)
[997] See n655
[998] See n584
[999] K Llewellyn, 'The Normative, the Legal, and the Law-Jobs: The Problem of Juristic Method' (1940) 49 *Yale Law Journal* 1355; TT ARVIND and JOANNA GRAY (n 697) n3
[1000] See Chapter V 5.2.2

of each other. Regulation can make up for the shortcomings of standards of private law, which has uncertainties, lacks the assessment of externalities, and other characteristics such as ex-post and passive monitoring and onerous accessibility.[1001] Private law can supplement regulation in its selective monitoring and enforcement and its vulnerability to outer influence.[1002]

However, the reality in the financial services sector in the UK does not show harmonized interplay between the two institutions. The regulator sees private law as risk to avoid and tries to solve problems it faces within its ambit without cooperation with the process of private law.[1003] The court prioritizes coherence within its own internal logic, modes of reasoning and principles and tends to ignore regulatory standards which, if adopted, might disturb its equilibrium.[1004] The statute, which had aimed for enforcement of statutory regulation by private law, has rather functioned to preserve the dissonance between them.[1005] The recent IRHPs scandal has well exemplified the lack of interplay; the court adjudicated the cases only based on its principles[1006]; the regulator in an opaque way arranged for compensation excluding the court[1007]; so different results came out between in the two institutions for the same disputes.

[1001] See Chapter VI 6.1
[1002] Ibid
[1003] See Chapter VI 6.2.4
[1004] Andrew Robertson, 'Constraints on Policy-Based Reasoning in Private Law in Robertson' in Andrew, and Hang Wu Tang (eds) *The goals of private law* (Bloomsbury Publishing 2009) n42
[1005] See p188
[1006] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133; *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc* [2013] EWHC 3167 (QB); *John Green and Paul Rowley v The Royal Bank of Scotland Plc* [2012] EWHC 3661; [2013] EWCA Civ 1197; *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc* [2014] EWHC 3043 (Ch); *Thornbridge Limited v Barclays Bank Plc* [2015] EWHC 3430; see also Table 2 at 107
[1007] See Chapter III 3.2.2

The dissonance of standards and the lack of interplay between the two institutions create legal uncertainty in the financial services sector,[1008] as the same type of behaviour is seen as wrongdoing under financial regulation but is not a breach of private law. More importantly, this prevents the financial market from setting up moral norms in regards to transactions of financial products between financial institutions and consumers and hence can incite opportunistic behaviours of market participants such as avoiding their responsibilities and liabilities by selectively turning to more favourable standards.[1009]

It has been argued that, in order to enhance harmonized interplay between the two institutions, compliance with regulation should be positioned as the minimum requirement in private law and causation test in private law should be relaxed. Regulation as the minimum requirement in private law means that breach of regulatory obligation will be acknowledged as breach of a duty of care in private law, but compliance with regulatory obligation cannot guarantee immunization from liability by private law. For this, the statutory “right of action” for breach of regulatory rules, which is now entitled only to private persons, should be extended to all consumers except for financial institutions. Regulatory rules such as the COBS already differentiates the level of protection by different consumer groups and so the statutory “right of action” should be granted to all consumers. [1010] By this statutory “right of action” all consumers can ask the court to enforce regulatory rules while the court will still be able to impose more duties, when it is necessary, on financial institutions than regulatory requirements. The extended “right of action” will

[1008] See n793
[1009] See n794
[1010] See n939

make regulation the minimum requirements of private law and allow private law to have more room for developing its own principles.

In relation to relaxing the causation test in private law, for cases brought by the "right of action" for regulatory breach, as Law Commission pointed out,[1011] the current test of causation including factual and legal causation in private law is very difficult for consumers to prove and this also hinders private enforcement of regulation. The current strict causation test does not allow regulation to be enforced as the minimum requirement of private law in the court. Therefore, it was recommended that for cases brought by the statutory right of action, the causation test in private law should be changed to the 'significance' test.[1012]

However, more research should be extended to investment transactions and other financial services sectors such as banking and insurance because the legal reforms that this thesis has proposed is mainly based on the over-the-counter derivatives transactions. Each financial services sector has sector-specialized statutory rules such as BCOBS (Banking: Conduct of Business Sourcebook), MCOB (Mortgage: Conduct of Business) and ICOBS (Insurance: Conduct of Business Sourcebook), which contains each sector's own attributes, and in those sectors, "mis-selling" of financial products can occur anytime. As each financial services sector has its own specialized statutory regulation, the dissonance between the regulation and private law might have different aspects from each other.[1013]

7.2 Implication of the thesis

[1011] The Law Commission and the Scottish Law Commission, *Consumer Redress for Misleading and Aggressive Practice* (LAW COM No 332, SCOT LAW COM No226) para 7.116
[1012] Ibid
[1013] Financial Conduct Authority, FCA Handbook

The thesis has revealed, through the example of "mis-selling" of over-the-counter derivatives, the contemporary trend of the expansion of the role of regulation and the shrinking role of private law in both standard-setting and enforcing standards. However, considering the weaknesses of regulation and the complementarity it can have with private law,[1014] the crowding out of private law is not desirable.[1015]

To enhance harmonized interplay between private law and regulation in the financial services sector, the thesis has proposed to the extension of the statutory right of action for breach of regulatory duties to a broader range of consumers and a relaxation of the burden of proof of causation. It is argued that these proposals should not be seen as instrumentalizing private law for regulatory purposes but as a way to help the evolution process of private law. Private law can be characterized by the steady adaptation of its standards to the changing social environments,[1016] and regulation can be the trigger of private law's evolution process.[1017] As shown before, however, the partially given statutory "right of action" hampers private law from absorbing regulatory standards in its system.[1018] Strict pursuit of precise causation of private law works as an impetus for financial market participants, including the regulator and consumers, to avoid private law as a resolution system for disputes and hence deprives private law of opportunities to deal with the disputes and so to develop its standards in line with changing environments.[1019]

However, the legal reforms this thesis has suggested are not a complete measure to achieve harmonized interplay between private law and regulation. The extended statutory

[1014] See Chapter VI 6.1.4
[1015] TT ARVIND and JOANNA GRAY (n 697) 4-8
[1016] Alastair Hudson, 'The synthesis of public and private in finance law' (n572) 247
[1017] TT ARVIND and JOANNA GRAY (n 697) 6; *Shore v Sedgwick Financial Services Ltd* [2008] PNLR 244 [161]
[1018] See p921
[1019] Joanne P Braithwaite, 'OTC derivatives, the courts and regulatory reform' (n 41) n33

right of action for regulatory breach and relaxed causation test can just be an institutional foundation but not a sufficient condition to enable harmonization of the two institutions. For full harmonized interplay, more research is needed to find what roles private law should play under the environment of the ambit of regulation being expanded.

For instance, in its formulation of principle, private law should find a way to integrate regulatory requirements with its own standards even when regulation constitutes the minimum requirement of private law. From this perspective, the establishment of a financial court dedicated to the financial industry, even though claims of only more than £50 million can be brought to this court, is a good step for private law in developing its advanced standards in the financial sector and in keeping in pace with fast changing financial industry.[1020] In the enforcement of standards, the difficult accessibility of consumers to private law is to be solved. As Lord Thomas acknowledged that there are few people except for very wealthy individuals, who can take advantage of private law redress for resolving their claims,[1021] Efforts should continue to make private law redress and enforcement of regulatory norms more accessible to consumers in financial services.

[1020] Civil Procedure (Amendment No. 4) Rules 2015, SI 2015/1569, Part 63A; Lord Thomas of Cwmgiedd, 'Speech at the Dinner for Her Majesty's Judges' (Mansion House, London, 8 July 2015), www.judiciary.gov.uk/wp-content/uploads/2014/07/lcj-speech-mansion-house-dinner-for-hm-judges.pdf, 4

[1021] Owen Bowcott, 'New financial court to hear UK and international market cases', *The guardian* (London 10 July 2015) <http://www.theguardian.com/law/2015/jul/10/new-financial-court-to-hear-uk-and-international-market-cases> accessed on 28th June 2016

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