THE LIABILITIES OF FINANCIAL ADVISORS

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The advice given by Financial Advisors, both the tied agents of life offices and independent financial advisors, is under close scrutiny. Attention is primarily directed to the sale of personal pension plans and advice to clients to transfer from occupational pension schemes to personal pensions. Press reports have suggested that the cost of compensating clients could run into many millions of pounds.

In ascertaining who is likely to have to pay such compensation the legal liabilities of both company representatives and independent financial advisors will inevitably come under close scrutiny. Surprisingly, although it is more than six years since the Financial Services Act 1986 came into force, the Act and the rules under it have to date received only limited legal attention. Two rules are likely to form the basis under which compensation may be payable to clients - Know your Customer and Give Best Advice.

Know Your Customer:-

"Before performing any service for a client, you must obtain and record the personal and financial information necessary to make appropriate recommendations." (Fimbra Rule 29.4.1(1)).

There are similar requirements in the SIB's Core Conduct of Business Rules and the Lautro Rules.
The SIB's recent review of the selling of personal pension plans involving transfers from occupational pension schemes suggests that in many cases these Rules have been breached. In a report to the SIB by KPMG Peat Marwick in December 1993, KPMG concluded that in 83% of cases reviewed, the file lacked evidence of sufficient "Know Your Customer information". Does it inevitably follow that in each of these cases the life office or independent financial advisor will be under an obligation to pay compensation to the customer?

Causation

Section 62 of the Financial Services Act 1986 provides that:-

"(1) A contravention of (a) any rules or regulations made under this Chapter (of the Act) ... shall be actionable at the suit of a person who suffers loss as a result of the contravention subject to the defences and other incidents applying to actions for breach of statutory duty."

"(2) Sub-section (1) applies also to a contravention by a member of a recognised self-regulating organisation ... of any rules of the organisation ... relating to a matter in respect of which rules or regulations have been or could be made under this Chapter .."

It is clear that there have been breaches of the "Know Your Customer Rules". However, a cause of action under Section 62 of the Financial Services Act requires both that there has been a breach of the rules and that the breach has caused loss. The question of causation is far from straightforward.

If the "Know Your Customer Rules" had been fully complied with, what information would this have revealed? The lack of information does not necessarily mean that the client had been badly advised. What is most likely is that a full review of the position would have revealed that the advantages and disadvantages of the proposed investment were finely balanced. Would the investment then have been made nonetheless? That is pure speculation.

Whilst there are authorities which suggest that damages can and should be awarded for loss of opportunity, the most recent authorities suggest that such cases are unusual. In *Hotson -v- East Berkshire Area Health Authority (1987) AC 750,* where a hospital's negligence deprived a patient of a 25% chance of making a nearly full recovery, the House of Lords held that no damages could be recovered because it had not been proved on the balance of probabilities that the hospital's negligence had been a material cause of the patient's disability. If this line of authority is followed, then a customer would have to prove that had full advice been given after compliance with the "Know Your Customer Rules", he would have made a different investment decision.

Even this may not be sufficient. In *Banque Financiere De La Cite SA -v- Westgate Insurance Co Ltd (the Skandia case) (1991) 2 AC 249 at 279* Lord Templeman held that a distinction must be made between:-

"the cause of the advance and the cause of the loss of the advance."

Lord Templeman's dictum was applied by Mr Justice Phillips in *Banque Bruxelles Lambert SA -v- Eagle Star Insurance Co Limited and Others* (Unreported 21st December 1993) to hold that a valuer who provides a negligent valuation is not liable for loss attributable to the collapse of the property market. Mr Justice Phillips said:-

"It does not seem to me that such loss can fairly and reasonably be considered as resulting naturally from (the valuer's) failure to report as they should have done. Where a party is contemplating a commercial venture that involves a number of heads of risk and obtains professional advice in respect of one head of risk before embarking on the adventure, I do not see why negligent advice in respect of that head of risk should , in effect, make the adviser the underwriter of the entire adventure. More particularly, where the negligent advice related to the existence or amount of some security against risk in the adventure, I do not see why the adviser should be liable for all the consequences of the adventure, whether or not the security in question would have protected against them."

In order to establish a claim under Section 62 of the Financial Services Act because of a failure to comply with the "Know Your Customer" rules, a Plaintiff must therefore prove:-

1) That there has been a breach of the Rules.

2) That without that breach a different investment decision would have been made.

3) That the advisor's bad advice not only caused the investment to be made but also caused the loss of the investment.

On each of these points the burden of proof is on the Plaintiff.

Give Best Advice

Rule 16 of the SIB's Core Conduct of Business Rules provides that:-

"A firm must take reasonable steps to ensure that it does not in the course of regulated business or associated business:

a) make any personal recommendation to a private customer of an investment or investment agreement ...

unless the recommendation or transaction *is suitable for him* having regard to the facts disclosed by that customer and other relevant facts about the customer of which the firm is, or reasonably should be, aware."

This rule also appears in the SROs.

What is "suitable"? In particular, is it possible to assert that only one category of advice is suitable?

The common law of negligence recognises that in any situation there is a range of advice which can be given without being negligent. Moreover, the test of whether advice is negligent at common law is whether it is advice which a reasonably competent professional could have given. The test is set out in *Bolam -v- Friern Hospital Management Committee (1957) 1 WLR 582* when Mr Justice McNair said:-

"Negligence means failure to act in accordance with the standards of reasonably competent (professional) men at the time .. There may be one or more perfectly proper standards; and if he conforms with one of these proper standards, then he is not negligent .. He is not guilty of negligence is he has acted in accordance with a practice accepted as proper by a responsible body of (professional) men skilled in that particular art ... A man is not negligent, if he is acting in accordance with such a practice, merely because there is a body of opinion which would take a contrary view ... It is not essential for (the Court) to decide which of two practices is the better practice, as long as (it accepts) that what the defendants did was in accordance with the practice accepted by responsible persons".

The essence of the common law test of negligence is that the standard of any professional is determined by the practice of the profession in question, and that a range of different solutions are acceptable. Have the Conduct of Business Rules changed this fundamental principle? We do not know until the question is answered by the Court. The industry will argue that the obligation to give best advice is merely a re-enactment of the common law rule not to be negligent. This argument may be supported by paragraph 2 of Lautro's code of conduct - The General Principle of Fair Dealing - which states that:-

" A company representative shall exercise due skill, care and diligence in his business dealing and shall deal fairly with investors."

The words "due skill, care and diligence" are a formulation of the common law standard of care in negligence. On the other hand, the obligation not to be negligent is generally categorised as a duty "to take *reasonable* care". If best advice was an obligation not to be negligent, it might be that the rule would have referred to the recommendation as being reasonable. That pre-supposes a range of possibilities. Instead the word "suitable" is used. "Suitable" is defined in the Oxford Dictionary as meaning " right or appropriate for the purpose or occasion etc". It is thus arguable the use of this word implies that in any scenario there is only one suitable solution, which is an external standard.

The interpretation of the obligation to give best advice is not a mere academic debate. Under the common law of negligence, where the standard is tested by the practice of the profession at the time, if a professional advisor gives advice which was being given by a significant number, even though only a minority, of other professional advisors at the time, he is not negligent. Advice to opt out of occupational pension schemes was regarded by a substantial number of financial advisors as good advice. There may, therefore, be a good defence to a claim in negligence. On the other hand, if the obligation to give best advice imposed an external standard, then there may have been a failure to give "Best Advice:".

Who will decide Liability?

If there have been widespread breaches of the Financial Services Act and the Conduct of Business Rules, how is it to be ensured that customers are properly compensated? Each customer who has been adversely affected will be entitled to bring proceedings against the financial advisor for compensation under Section 62 of the Financial Services Act, and possibly also at common law in negligence. However, for many customers, especially those ineligible for Legal Aid, the cost of bringing proceedings for a relatively small loss may be prohibitive.

Section 61 of the Financial Services Act 1986 may provide assistance. This section provides that:-

"If on the application of (the SIB) the court is satisfied - (c) that any person has contravened (i) rules or regulations made under this Chapter; ... or (4) the rules of a recognised self-regulating organisation ... to which that person is subject and which regulate the carrying on by him of investment business) and that there are steps that could be taken for remedying the contravention, the court may ... make an order requiring that person and any other person who appears to the court to have been knowingly concerned in the contravention to take such steps as the court may direct to remedy it."

Section 61 therefore enables the SIB to bring an action for the benefit of investors where there have been breaches of the SRO rules.

The SIB Core Conduct of Business Rules may provide an alternative route under which life offices and independent financial advisors may be forced to pay compensation. Rule 35 provides that:-

"A firm must have procedures to ensure:

a) the proper handling of complaints from customers ...

b) that any appropriate remedial action on these complaints is promptly taken."

Similarly in the Lautro rules a member of Lautro is guilty of misconduct if he contravenes or fails to company with any of the Lautro rules. Where it appears to the Monitoring Committee of Lautro that a member has been guilty of misconduct, the Monitoring Committee may request the member "to take such action as appears to the Committee to be appropriate".

Where a complaint from a customer or a finding of the Lautro Monitoring Committee indicates that there has been a breach of the Lautro rules causing the customer loss, then appropriate remedial action is likely to be a requirement to pay compensation. This however begs the question whether the breach of the Rules has caused the customer loss. That raises all the legal issues as to the definition of best advice and the law of causation set out above. Is it open to the Lautro Monitoring Committee under its power to request a member to take appropriate action to require that member to pay compensation in circumstances where the member is under no legal obligation to do so? Such a proposition would appear unlikely.

Most of the major life offices are members of the Insurance Ombudsman Scheme. Most complaints regarding investment business are likely to fall within the

Ombudsman's jurisdiction and to be made by clients to the Ombudsman. The Ombudsman's terms of reference require him:-

"To have regard to and act in conformity with:-
a) the terms of any contract;

b) any applicable rule of law, judicial authority of statutory provision; and

c) the general principles of good insurance investment or marketing practice, the ABI's Statements and Codes of Insurance Practice, and the TRO and IMRO rules but with (c) prevailing over (b) in favour of the complainant."

(Trial terms of reference for use during 1994).

It had been held by the Divisional Court in *R -v- Insurance Ombudsman Ex Parte Aegon Life Assurance Limited (Unreported 16th December 1993)* that the Ombudsman's terms of reference "expressly contemplate decisions more favourable to complainants than the law would provide." The Divisional Court also held that the Ombudsman was not susceptible to judicial review.

It therefore appears that there may be strong legal defences available in respect of many of the anticipated claims facing the life insurance industry, but because procedurally most claims are likely to be made through the Insurance Ombudman, it may be impossible for the legal defences ever to be taken. The result may be to leave the industry with a substantial liability which could otherwise have been avoided, whilst at the same time leaving the legal issues set out in this article undecided.