

Regulatory obligations and implied contractual terms

In the case of *Redmayne Bentley Stockbrokers v Isaacs* (June 2010), the High Court considered whether the "suitability" obligations imposed by MiFID and implemented in COBS 9 of the FSA Handbook have the effect of changing the contractual relationship between a firm and its client, even though the express terms of the contract made no reference to the firm's regulatory duties.

The defendant held or controlled various dealing accounts with Redmayne on which he had evidently over-reached himself so that, at the onset of the financial crisis in the autumn of 2008, he allegedly owed the firm almost £600,000.

When Redmayne sued for recovery, the defendant counterclaimed that the firm was in breach of contract for allowing him excessive credit and that it should have intervened to prevent excessively risky transactions, on the grounds that the firm had an advisory relationship with him and was therefore bound to consider the suitability of the transactions.

Although the judge held (on the somewhat convoluted facts relating to the client documentation) that the relationship was one of "execution-only", he did consider the defendant's case on the basis that the relationship was an "advisory dealing" relationship, under which advice was sometimes given, but also under which the client might give dealing instructions without taking prior advice.

This raises the question of whether, if there is an advisory element to a client relationship, the suitability requirement applies to all dealings for that client, whether the client is advised or not?

Counsel for the defendant contended that:

"...in the light of the changes made by MiFID it is no longer possible for a stockbroker to offer advice on occasions. If advice is offered at all then an advisory service is deemed to be provided and the COBS assessment of suitability requirements would apply to all transactions carried out on that account, whether or not advice is sought or given in relation to them. The implied term [to the contract between the firm and the client] was accordingly necessary to reflect regulatory requirements."

The judge rejected this argument on two grounds. First, that MiFID has no such effect, and second, that regulatory duties do not require contractual expression.

MIFID HAS NO SUCH EFFECT

The judge noted that the MiFID suitability requirements in respect of advice, as implemented in COBS 9, apply where a "personal recommendation" is made. This concept is tied to a recommendation in respect of a "specific transaction". Only then is the suitability requirement engaged.

If a client gives dealing instructions without seeking advice, so that there is no "personal recommendation" in respect of that particular transaction, no COBS suitability obligation arises. In other words, a firm can, as it could before the implementation of MiFID, continue to have a relationship with a client which contains both advised and execution-only dealings.

REGULATORY DUTIES DO NOT REQUIRE CONTRACTUAL EXPRESSION

The judge also confirmed an extremely important point which is often overlooked. Regulatory requirements are independent of the contractual relationship between a firm and its client. It is not necessary to imply them into the contract (or indeed to have an express term referring to them):

"... if the position is in any event covered by regulatory requirements, in respect of which there would be a cause of action for breach of statutory duty, it is difficult to see any necessity for implication, or why the contract would be unworkable without such term."

Firms that undertake in contract to fulfil their regulatory obligations therefore unnecessarily increase their exposure to clients without gaining any benefit for themselves.

IS THERE A CONTRACTUAL DUTY TO ADVISE AGAINST EXCESSIVE RISK TAKING?

Even if, as the judge found, MiFID and COBS do not have the wide effect contended for by the defendant, is there nevertheless a contractual duty for a broker to "consider and advise against excessive risk taking"? The defendant argued that the "clear tenor" of the MiFID reforms supported this conclusion, even if there was no express regulatory requirement. The judge held that this was to take the concept of an advisory relationship too far – even in the case of a transaction where advice had in fact been given:

"The broker's duty is advisory. Investment decision remains that of the client. Provided that proper advice has been given I do not accept that the broker would be under an implied obligation to go further and prevent any investment being made contrary to the advice given. That is not a necessary obligation for the working of the advisory relationship. It is also contrary to the broker's duty as an agent to follow his principal's instructions".

DUTY TO EXERCISE REASONABLE SKILL AND CARE

Somewhat intriguingly, the judge ended his analysis of the law by indicating a line of argument which the defendant should, perhaps, have explored further.

There is indeed a contractual duty to exercise reasonable skill and care in carrying out services and the judge acknowledged that there may well be "cases where a stockbroker does owe a duty to make an assessment of suitability and advise accordingly". Whether or not the defendant's case might have been one of these cases was not, it appears, argued. However, the judge ended by saying:

"COBS 9 and the assessment of suitability which it requires is likely to be highly relevant to what the duty of skill and care requires in a particular case".

COMMENT

The judge's reasoning appears to be sound. In summary:

- A firm can offer advisory and execution-only services to the same client. There will be no suitability requirement in respect of execution-only services.
- Regulatory requirements are not implied into the contractual relationship unless the parties choose to do so.
- A firm does, however, always have a duty to exercise reasonable skill and care in carrying out its services.

In respect of the final point, where a firm is carrying out an execution-only transaction, the duty is presumably limited to exercising skill and care in the execution of the transaction (that being the service to be provided) and not to warn the client against the consequences of his own decision.

However, there may be cases that fall into a grey area between “execution-only” and “personal recommendation” where the duty of skill and care may involve some consideration of suitability. It can be expected that future firm-client litigation over market losses suffered will focus further on this grey area.

RECOMMENDATIONS

Lessons (some more obvious than others) may be drawn by both brokers and their clients:

- Both parties should agree in clear terms what services are to be provided and the terms of business should properly reflect that agreement (standardised terms of business may not always be appropriate).
- Brokers may now wish to avoid giving a contractual undertaking to obey regulatory requirements.
- Where both advisory and execution-only services are to be provided, insofar as practicable individual brokers should make explicit, and ideally document, the understanding as to which service is being provided on each occasion.
- Clients, especially experienced and/or professional clients, who have signed up to an execution-only service should note that the actual tendering of advice by a broker from time to time will not necessarily alter the contractual relationship – see further the case of *JP Morgan v Springwell Navigation*, discussed in our Briefing Paper of July 2008. This case applied the legal principle of “contractual estoppel”, to the effect that where parties have clearly agreed an execution-only relationship, then the giving of advice will not of itself alter the contractual position unless it can otherwise be shown that the contract has been varied.
- Brokers should at the same time recognise that regulatory requirements may nevertheless apply to advice provided to a client in these circumstances, notwithstanding that the contractual relationship with the client may not provide for such protections.

If you would like to discuss the issues raised in this briefing paper, or any other financial regulatory matter, please contact one of the following or your usual Slaughter and May contact:

Ruth Fox: ruth.fox@slaughterandmay.com
Jan Putnis: jan.putnis@slaughterandmay.com
Ben Kingsley: ben.kingsley@slaughterandmay.com

Slaughter and May
One Bunhill Row
London EC1Y 8YY
United Kingdom

T +44 (0)20 7600 1200
www.slaughterandmay.com