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International Issues in the Regulation of Financial Advice: A United Kingdom Perspective--The Retail Distribution Review and the Ban on Commission Payments to Financial Intermediaries

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INTERNATIONAL ISSUES IN THE REGULATION OF FINANCIAL ADVICE: A UNITED KINGDOM PERSPECTIVE—THE RETAIL DISTRIBUTION REVIEW AND THE BAN ON COMMISSION PAYMENTS TO FINANCIAL INTERMEDIARIES

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Investment products, such as company shares and government bonds, have always been an important item of wealth, although traditionally limited to a minority or the elite of society.[1] Life insurance, which often performs an investment function, permits many millions to participate indirectly in the financial markets, as do pension products.[2] However, it is commonly said that life insurance is not bought and has to be sold. That may be true of investments more generally, and the role of financial intermediaries and salespersons has been critical in persuading individuals of the wisdom of contributing to pensions, investing in mutual funds, and making other investments, as opposed to buying a bigger house or automobile. In 2008, Lord Justice Rix in the English Court of Appeal observed:

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[1] *See* Stuart Banner, ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690–1860, at 24 (1998) (discussing the rise of a securities market in late seventeenth-century England and noting, "As the secondary market in government debt and shares of businesses grew, the portion of the nation's total wealth consisting of land and other tangible things gradually declined, replaced more and more by mobile pieces of paper, representations of intangible fractions of a future stream of income. Within a generation, contemporaries came to realize that an entirely new form of property had come into existence.").

[2] R in re Heather Moor & Edgecomb Ltd. v. Fin. Ombudsman Serv., [2008] EWCA (Civ.) 642, [87] (Eng.).

> It is a feature of our commercial law, robust, pragmatic and internationally respected as it may be, that it grew up in an age of commerce between merchants, when what we now think of as financial consumer contracts must have been relatively few in number, limited in their scope, and entered into by a small range of professional, mercantile and landowning people. I speak of contracts outside ordinary sale of goods. Nowadays, however, huge numbers of consumers have pensions, make investments, and enter into insurance contracts of all kinds.[3]

The value added by financial intermediaries and salespersons is recognized by the often sizeable commissions paid by life insurers and other financial product providers to them when a deal is done. Given that the legal position is that independent financial intermediaries are the agents of investors, and not the product providers, this has always been difficult to reconcile with principles of fiduciary law. In particular, the potential for a conflict of interest is obvious. One solution is a regime of disclosure, although the extent of disclosure necessary has been much debated. The United Kingdom appears to have traditionally followed a disclosure model, at least for less sophisticated retail customers.[4] However, U.K.'s financial regulator has resolved that, with effect from December 31, 2012, the appropriate solution to the conflict risk is to ban outright all payments by product providers to intermediaries.[5] This Article describes in a little more detail that step and how the U.K. got there.

I. THE U.K. INDUSTRY, REGULATORY CONTEXT, AND REGULATION OF INVESTMENT BUSINESS

A. *The United Kingdom Financial Services Industry*

The U.K. financial services industry constitutes a significant component of its economy. It is composed of three main sectors: banking, insurance, and investment business. Even in the wake of the 2007–2008 financial crisis, the contribution of the financial

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[3] *Id.*

[4] *See, e.g.*, FIN. SERVS. AUTH., CONDUCT OF BUSINESS SOURCE BOOK ¶ 2.3.1 (2013) [hereinafter CONDUCT OF BUSINESS SOURCE BOOK].

[5] *See* HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: THE BLUEPRINT FOR REFORM, 2011, Cm. 8083, ¶¶ 1.39–.44 (U.K.) [hereinafter BLUEPRINT FOR REFORM].

services industry to the U.K. economy was still significant.[6] Financial services accounted for some eight percent of gross domestic product ("GDP") and they contributed some £38 billion net to the U.K.'s balance of payments.[7] Over one million people are employed in the financial services industry in the U.K., a third of them in London, but the remainder spread out across the U.K., overall some five percent of the workforce.[8] Over 24,500 separate firms constitute the regulated financial services industry.[9]

B. *Financial Crises and Legislative Reaction*

The U.K. experience of greater participation in modern financial products has been far from a uniformly positive one. Between 1988 and 1994, it was estimated that between one million and two million ordinary investors were sold the wrong type of pension.[10] They were persuaded to opt out of, or not join, occupational pension schemes, with defined benefits, and instead take out an investment product-based pension usually offered by life insurance companies. The latter involved greater exposure to market risk and fewer benefits than the occupational schemes. Such investors faced a potentially significant financial loss. The scale of the pension mis-selling scandal and its financial extent were unprecedented.[11] The final estimated bill for compensation exceeded £12 billion.[12] What were the causes of mis-selling?

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[6] HM TREASURY, REFORMING FINANCIAL MARKETS, 2009, Cm. 7667, ¶ 1.6 [hereinafter REFORMING FINANCIAL MARKETS].

[7] *Id.*

[8] *Id.* ¶¶ 1.6, 1.9. Compare these figures to the European Union average of 2.5% of employment in the financial services sector. *Commission of the European Communities, Report from the Commission: Progress on Financial Services*, at 3, COM (2000) 336 final (May 30, 2000).

[9] FIN. SERVS. AUTH., THE FINANCIAL CONDUCT AUTHORITY: APPROACH TO REGULATION ¶ 1.10 (2011) [hereinafter APPROACH TO REGULATION].

[10] *See* SELECT COMMITTEE ON TREASURY, THE MIS-SELLING OF PERSONAL PENSIONS, 1998, ¶¶ 1–2 (U.K.), *available at* http://www.publications.parliament.uk/pa/cm199798/cmselect/cmtreasy/712/71203.htm.

[11] For detailed discussion of the saga, see generally Gerard McMeel, *The Consumer Dimension of Financial Services Law: Lessons from the Pension Mis-selling Scandal*, 1 COMPANY, FIN., & INSOLVENCY L. REV. 29 (1997); Julia Black & Richard Nobles, *Personal Pensions Misselling: The Causes and Lessons of Regulatory Failure*, 61 M.L.R. 789 (1998); Gerard McMeel, *Liability of Financial Advisers in the Wake of the Pension Mis-selling Scandal*, 13 PROF. NEGL. 97 (1997).

[12] Rupert Jones, *Mis-selling Bill Tops £13bn*, GUARDIAN (Dec. 1, 2000), http://www.theguardian.com/money/2000/dec/02/personalfinancenews.business.

Payment to salespersons by commission was a cause emphasised by many commentators. In the House of Lords in *Lloyds TSB General Insurance Holdings v. Lloyds Bank Group Insurance Co. Ltd.*,[13] Lord Hoffmann accepted this was one of the key factors, although putting payment by commission into perspective: "The underlying reasons for mis-selling were partly the method by which salesmen were paid but largely the inadequacy of the training and monitoring of their peformance provided by the companies employing them."[14]

The pension mis-selling scandal was one of the principal reasons cited for the financial regulatory reforms undertaken by the Labour Government elected in May 1997. Similar mis-selling problems were experienced with home income plans or equity release mortgages marketed to elderly investors. In addition, there was widespread endowment policy mis-selling in the retail mortgage sector. The total cost of redress for the industry was £3 billion.[15] In 2000, in the wake of Equitable Life's near-collapse, "with profits" life insurance products fell under a cloud, and the issue of compensation for policyholders had rumbled on for more than a decade. The payment protection insurance ("PPI") mis-selling scandal, which embraced banks, credit card companies, and other credit providers, resulted in £5.9 billion being paid out in compensation between January 2011 and July 2012, with the final bill yet to be ascertained.[16] The Financial Services Authority ("FSA") estimated that the total bill for compensating consumers for all of these financial scandals was some £15 billion, with the bulk of PPI compensation yet to come.[17] Lord Turner, the Chairman of the FSA, writing in January 2011, accepted that the regulator's sales-focused philosophy "has not been effective in preventing waves of . . . consumer detriment."[18]

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[13] Lloyds TSB Gen. Ins. Holdings v. Lloyds Bank Grp. Ins. Co. Ltd., [2003] UKHL 48 (appeal taken from Eng. & Wales).

[14] *Id.* ¶ 5.

[15] OLIVER WYMAN, MIS-SELLING IN THE UK 7 (2011), *available at* https://web.actuaries.ie/sites/default/files/event/2011/07/111020%20ERM%20Forum%20-%20Daniel%20Mikkelsen.pdf.

[16] The FSA published a monthly update on PPI refunds and compensation payments to date. *Monthly PPI Refunds and Compensation*, FIN. SERVS. AUTH., http://www.fsa.gov.uk/consumerinformation/product_news/insurance/payment_protection_insurance_/latest/monthly-ppi-payouts (last updated Aug. 8, 2013).

[17] APPROACH TO REGULATION, *supra* note 9, ¶ 1.1.

[18] FIN. SERVS. AUTH., DISCUSSION PAPER 11/1: PRODUCT INTERVENTION 3 (2011); *see also id.* ¶¶ 2.3–.4, 5.14; Adair Turner, Chairman, Fin. Servs. Auth. (U.K.),

Since then, further concerns have arisen from what the FSA has determined are serious failings in the sale of interest rate hedging products by banks to small and medium-sized businesses, with banks undertaking to review sales and provide redress where appropriate.[19] In July 2012, the London Inter-Bank Offered Rate ("LIBOR") fixing scandal broke. LIBOR is used both for setting commercial lending rates and in determining some U.K. residential mortgage interest rates. Martin Wheatley, the Managing Director of the FSA and Chief Executive Officer-designate of the new Financial Conduct Authority, has been appointed by George Osborne, the Chancellor of the Exchequer, to conduct a review of the benchmark rate and how it should be reformed or replaced.[20]

The "freezing" of wholesale money markets in September 2007 saw the first "run" on a U.K. bank, Northern Rock, since the Overend and Gurney collapse in the nineteenth century. The stricken former building society, similar to a Savings & Loan, was eventually fully nationalized in February 2008.[21] More was to follow later in the year in the wake of the "credit crunch," with the near-collapse of the U.K. banking industry averted by massive capital injections and corporate acquisitions and restructuring. By January 2009, the Chairman of the FSA, Lord Turner, observed ruefully: "[T]he world financial system—and particularly but not exclusively the world banking system—has suffered a crisis as bad as any since the stock market crashes of 1929 and the various banking crises that followed."[22] In December 2011, the FSA published its report on the near-

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Speech at the British Bankers' Association Conference: Protecting Consumers and Winning Trust (July 13, 2010).

[19] FIN. SERVS. AUTH., INTEREST RATE HEDGING PRODUCTS: INFORMATION ABOUT OUR WORK AND FINDINGS 1 (2012), *available at* http://www.fsa.gov.uk/static/pubs/other/interest-rate-hedging-products.pdf.

[20] HM TREASURY, THE WHEATLEY REVIEW OF LIBOR: INITIAL DISCUSSION PAPER ¶ 1.1 (2012), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191763/condoc_wheatley_review.pdf; *see also* Martin Wheatley, Managing Dir., Fin. Servs. Auth. (U.K.), Speech at Bloomberg: Wheatley Review—The Future of LIBOR (Aug. 10, 2012).

[21] *See generally* Northern Rock plc Transfer Order, 2008, S.I. 2008/432 (U.K.). The Temporary Banking (Special Provisions) Act 2008 has now been replaced by permanent legislation in the shape of the Banking Act 2009, which has already been used to rescue the Dunfermline Building Society. *See* Banking Act 2009, c. 1 (U.K.).

[22] Adair Turner, Chairman, Fin. Servs. Auth. (U.K.), Speech at The Economist's Inaugural City Lecture: The Financial Crisis and the Future of Financial Regulation (Jan. 21, 2009).

collapse of the Royal Bank of Scotland in October 2008. This followed its disastrous takeover of ABN-Amro. The bailout required a £45.5 billion equity capital injection from taxpayers' funds—a stake now only worth about £20 billion. The report exposed the multiple failings both at the bank and at the regulator.

C. From Multiple Functional Regulators to "Single Regulator"

The regulatory framework for U.K. financial services, which had developed over the course of the twentieth century, was complex and fragmented. There were multiple regulators, often more than one for each of the three sectors of the industry. The governing legislation and regulatory requirements were embodied in multifarious statutes, delegated legislative instruments, codes, and rulebooks. In addition, there existed various redress mechanisms and safety-net compensation schemes. The resulting picture was confusing for practitioners, let alone ordinary consumers. The Labour administration elected in May 1997 undertook a fundamental overhaul of the financial regulatory structure in the U.K. and decisively embraced what was portrayed as a single regulator model in the shape of the FSA. The Bank of England, the U.K.'s Central Bank, was stripped of its role as banking regulator by the Bank of England Act 1998, and the new regulator's powers were formalized under the Financial Services and Markets Act 2000 ("FSMA"). However the financial crisis of 2007–2008 raised questions about the role of the supposed "single regulator," its relationship with the Bank of England and the Treasury, the U.K.'s finance ministry—collectively, the so-called "tri-partite authorities." Further legislation followed in the wake of the financial crisis, including the temporary Banking (Special Provisions) Act 2008, the Banking Act 2009, which superseded the 2008 Act, and the Financial Services Act 2010.

Over a dozen years after the FSA was initially launched in 1997, and despite the lengthy legislative reform process culminating in the Financial Services and Markets Act 2000, financial regulatory reform remains high on the agenda. In July 2009, both the then U.K. Labour Government and the Conservative Party, then Her Majesty's Loyal Opposition, issued blueprints for the future. The Labour Government's 2009 White

Paper[23] was predictably focused on measures in respect of the banking sector and improved prudential and supervisory arrangements in the wake of the banking and financial crisis of 2007–2008.[24] It was clear that the Labour Government continued to regard the system which it had implemented in its first term—with the FSA as the principal regulator and a correspondingly reduced role for the Bank of England—as the appropriate one. The principal proposals in the 2009 White Paper were for a new Council for Financial Stability to facilitate cooperation between the Treasury, Bank of England, and Financial Services Authority, together with a new, explicit statutory objective for the Financial Services Authority of maintaining financial stability.[25] The Brown administration also accepted Lord Turner's conclusion that the Financial Services Authority had placed too much emphasis on conducting business regulation at the expense of prudential supervision of the crucial banking sector.[26] However, the proposed technical law reforms were limited. These proposals were to a large extent implemented in the Financial Services Act 2010, which received the Royal Assent before the May 2010 General Election.

D. The Proposals of the Coalition Government

Whilst in opposition, the Conservative Party, led by David Cameron, published its own rival and more wide-ranging proposals on financial regulatory reform (the "Opposition White Paper").[27] It boldly proposed the abolition of the Financial Services Authority, the return of prudential regulation of significant firms by the Bank of England, and a new Consumer Protection Agency, which, it appears, would embrace the Financial Services Authority's conduct of business remit, together with the consumer credit responsibilities of the Office of

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[23] REFORMING FINANCIAL MARKETS, *supra* note 6, at 6.

[24] *Id.* ¶ 2.1.

[25] *Id.* ¶ 4.29.

[26] *Id.* ¶ 4.58. This point is also emphasized by the Conservatives. *See* U.K. CONSERVATIVE PARTY, FROM CRISIS TO CONFIDENCE: PLAN FOR SOUND BANKING 15 (2009), *available at* http://www.conservatives.com/News/News_stories/2009/07/~/media/Files/Downloadable%20Files/PlanforSoundBanking.ashx.

[27] *See* U.K. CONSERVATIVE PARTY, *supra* note 26, at 15.

Fair Trading.[28] Essentially this appears to come close to embracing what is sometimes called the "twin peaks" approach to financial regulation, with separate regulators focusing on prudential supervision and conduct of business regulation respectively.

The formation of a Coalition Government—the first since World War II—of Conservatives and Liberal Democrats in May 2010, following the General Election, led to promises of further significant financial regulatory reform. The agreement which forms the basis of the Coalition Government stated that the financial regulatory system would be reformed to avoid a repeat of the financial crisis and that the Bank of England would be given control of macro-prudential regulation and oversight of micro-prudential regulation.[29] In his first Mansion House speech on June 16, 2010, new Chancellor of the Exchequer, George Osborne, confirmed that the Coalition Government did not believe that the current system of financial regulation was working.[30] He outlined a so-called "twin peaks" strategy—albeit he did not use that language—for separating prudential supervision from conduct of business regulation. The Financial Services Authority would cease to exist in its current form. Mr Osborne observed: "The FSA became a narrow regulator, almost entirely focused on rules based regulation."[31] A new Prudential Regulatory Authority ("PRA") would operate as a subsidiary of the Bank of England, which would oversee macro-prudential policy. A new Consumer Protection and Markets Authority would be responsible for conduct of business regulation for both retail and wholesale firms.

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[28] Under the proposals, the FSA would retain responsibility for both prudential and conduct of business regulation of 17,000 smaller firms, which are of limited concern to overall financial stability. *Id.* at 47.

[29] HM GOVERNMENT, THE COALITION: OUR PROGRAMME FOR GOVERNMENT 9 (2010), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/78977/coalition_programme_for_government.pdf.

[30] Tola Onanuga, *Emergency Budget: George Osborne's Speech in Full*, GUARDIAN (June 22, 2010, 10:27 AM), http://www.guardian.co.uk/uk/2010/jun/22/emergency-budget-full-speech-text.

[31] George Osborne, Chancellor of the Exchequer, Speech at the Lord Mayor's Dinner for Bankers & Merchants of the City of London: Check Against Delivery (June 16, 2010).

In July 2010, the Treasury published more detailed proposals in *A New Approach to Financial Regulation: Judgement, Focus and Stability* (the "Coalition White Paper").[32] The "tripartite system" whereby the Bank of England, the Treasury, and the FSA were all collectively and notionally responsible for financial stability was in part blamed for failings in the U.K. regulatory framework exposed by the financial crisis. It confirmed the proposed separation of responsibility for prudential supervision and conduct of business regulation. A new Prudential Regulation Authority would have operational responsibility for prudential regulation and would be a subsidiary of the Bank of England, which would be responsible for macro-prudential policy through a new Financial Policy Committee ("FPC") and would have oversight of micro-prudential policy.[33] A new Consumer Protection and Markets Authority ("CPMA") would be responsible for conduct of business regulation for both retail and wholesale firms. In the view of the Treasury, "Prudential and conduct of business regulation require different approaches and cultures."[34]

Chapter Four of the Coalition White Paper provided more detail on the proposed CPMA.[35] It was acknowledged that CPMA is a working title,[36] and in February 2011, the Coalition Government announced that it had finalized the name for this body as the Financial Conduct Authority ("FCA").[37] Given that the CPMA and FCA will be the same corporate entity as the FSA for cost reasons, as a matter of substance, the FCA appears to be essentially the FSA, albeit stripped of responsibility for prudential regulation.[38] The Coalition White Paper moots

[32] *See* HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: JUDGEMENT, FOCUS AND STABILITY, 2010, Cm. 7874 (U.K.) [hereinafter JUDGEMENT, FOCUS AND STABILITY]; *see also* HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: A SUMMARY OF CONSULTATION RESPONSES, 2010 (U.K.); HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: BUILDING A STRONGER SYSTEM, 2011, Cm. 8012 (U.K.) [hereinafter BUILDING A STRONGER SYSTEM].

[33] *See* JUDGEMENT, FOCUS AND STABILITY, *supra* note 32, at 9–30 (highlighting the detailed proposals).

[34] *Id.* ¶¶ 1.20, 4.2; *see also* BLUEPRINT FOR REFORM, *supra* note 5, ¶ 1.6.

[35] JUDGEMENT, FOCUS AND STABILITY, *supra* note 32, at 31–39.

[36] *Id.* ¶ 4.3.

[37] BUILDING A STRONGER SYSTEM, *supra* note 32, ¶ 1.10.

[38] JUDGEMENT, FOCUS AND STABILITY, *supra* note 32, ¶ 4.30.

developing and enhancing the FSA's own initiative variation of permission powers as a key regulatory tool of the FCA.[39] In terms of regulatory philosophy some continuity is stressed:

> [T]he CPMA will build on the progress recently made by the FSA towards a more interventionist and pre-emptive approach to retail conduct regulation. As a starting point, it will adopt the FSA's new Retail Conduct of Business Strategy, and it will continue with initiatives such as the Retail Distribution Review, Mortgage Market Review, and work on responsible lending. These initiatives recognise and respond to some of the distinctive characteristics of retail financial services that call for a more intrusive approach, such as long-term product payoffs, product complexity and asymmetry of information between consumers and producers. This will necessarily be backed by a strong approach to enforcement to ensure credible deterrence.[40]

Similarly, continuity is maintained in respect of complaints and compensation in that the proposals envisage the same roles for the Financial Ombudsman Service ("FOS") and the Financial Services Compensation Scheme ("FSCS") in the regulatory picture.[41]

E. The Financial Services Act 2012

In June 2011, the Treasury published a further consultation paper and White Paper attaching a draft Financial Services Bill,[42] or more precisely only the "core provisions needed to give effect to the reform proposals," with "many technical and consequential provisions" not yet drafted.[43] Critically, the 2011 White Paper evidenced the Coalition Government's decision not to wipe the slate clean and start again, but rather it intended to amend the Financial Services and Markets Act 2000.[44] The proposed core amending draft legislation was put forward for pre-legislative scrutiny. The centerpiece of the new financial services regime[45] is the new Financial Policy Committee ("FPC"), a committee of the Court of the Bank of England, with overall responsibility for the financial system and for macro-prudential

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[39] *Id.* ¶ 4.24.
[40] *Id.*
[41] *Id.* ¶ 4.43.
[42] BLUEPRINT FOR REFORM, *supra* note 5.
[43] *Id.* ¶ 1.17.
[44] *Id.* ¶ 1.18.
[45] *Id.* at 8 fig.1.A.

policy in particular, "sitting at the apex of the regulatory architecture."[46] It will be chaired by the Governor of the Bank of England, and the Chief Executive of the Financial Conduct Authority will be amongst the members.[47] Underneath the FPC, the new PRA would be a subsidiary of the Bank of England, with operational responsibility for prudential regulation of larger firms whose balance sheets make them relevant to the financial system and its stability as a whole, namely the banks, insurers, and larger investment firms.[48] Lastly, the new FCA will specialize in conduct of business regulation and promotion of confidence in financial markets, services, and products.[49] Its proposed new powers embrace the following: "product intervention" powers, which would permit the FCA to impose requirements on financial products or even to ban them; an ability to disclose the commencement of enforcement action; and improvements to the powers to deal with misleading financial promotions.[50] Broadly speaking, the roles of the FSCS and the FOS are being retained.[51]

Between July and December 2011, the draft Financial Services Bill underwent pre-legislative scrutiny by a "Joint Committee for the draft Financial Services Bill."[52] Following this scrutiny, the Treasury published a further consultation document[53] outlining further changes to the draft Bill, including major changes to the crisis management arrangements between the Treasury and Bank of England.[54] Furthermore, the revised Bill reflected the decision to transfer consumer credit regulation to the FCA. The Financial Services Bill was introduced into Parliament on January 26, 2012, which included significant changes from the draft Bill to the FCA's statutory objectives and its statutory principles of good regulation. The Bill also transfered full responsibility for regulation of consumer credit under the Consumer Credit Act 1974 to the FCA. The Financial

[46] *Id.* ¶ 1.29.

[47] *Id.* ¶¶ 1.25–.30.

[48] *Id.* ¶¶ 1.31–.38.

[49] *Id.* ¶¶ 1.39–.44.

[50] *Id.* ¶ 1.43; *see also* APPROACH TO REGULATION, *supra* note 9, ¶ 4.1.

[51] BLUEPRINT FOR REFORM, *supra* note 5, ¶¶ 2.196–.204.

[52] HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: SECURING STABILITY, PROTECTING CONSUMERS, 2012, Cm. 8268, ¶ 1.3 (U.K.).

[53] *Id.* ¶ 1.4.

[54] *Id.* ¶¶ 1.5–.12.

Services Act 2012 received the Royal Assent in December 2012 and therefore passed into law. The Coalition's aim is for the latest version of the U.K. financial regulatory system to be operational during the course of 2013.

F. The Regulation of Investment Business

Probably as a result of the numerous scandals, stability of the regulatory environment for U.K. investment business has not been a feature of the landscape. Prior to the reforms associated with the so-called "Big Bang" deregulation of the City of London in the second half of the 1980s, there was a rudimentary regime represented by the unambitiously-named Prevention of Fraud (Investments) Acts 1939 and 1958. Since the implementation of the Financial Services Act 1986 (the "1986 Act") there have been several major phases of regulatory rules in respect of investor protection in the retail financial sector. First, under the 1986 Act, from its implementation on April 29, 1988 to May 1, 1994, there was the initial regime comprising the regulatory rules of various Self-Regulatory Organizations ("SROs"), consciously modeled on the American approach. These SROs included, for the retail sector, the short-lived duo, the Life Assurance and Unit Trust Regulatory Organisation ("LAUTRO")—broadly speaking, the product providers—and the Financial Intermediaries, Managers and Brokers Regulatory Association ("FIMBRA")—representing the client-facing advisers and brokers. Secondly, under the same legislation, from 1994 to 2001, an amalgamated SRO, the Personal Investment Authority ("PIA") superseded LAUTRO and FIMBRA but to a large extent adopted its predecessors' provisions in its own rulebook. Now product providers and intermediaries were regulated by the same front-line regulator. Thirdly, under the Financial Services and Markets Act 2000 from December 1, 2001 ("N2") to October 2007, the Conduct of Business Sourcebook ("COB")[55] component of the Financial Services Authority's *Handbook of Rules and Guidance* consolidated and superseded its various predecessor regulators' rulebooks for the conduct of investment business.[56] After N2 COB was further amended on a number of fronts, including the

[55] *See* G. MCMEEL & J. VIRGO, FINANCIAL ADVICE AND FINANCIAL PRODUCTS: LAW AND LIABILITY ch 14 (2001). (discussing the original version of COB).

[56] Financial Services and Markets Act, 2000, c. 8 (U.K.).

depolarization initiative, which permitted intermediaries to be multi-tied to a defined number of product providers, whereas previously since the introduction of SRO regimes they had to be either tied to one provider or wholly independent. In mid-2005, the FSA proposed fundamental changes to COB.[57] The main impetus came from the need to implement new European law—the Markets in Financial Instruments Directive ("MiFID")—with effect from November 1, 2007 and resulting in the new Conduct of Business Sourcebook ("COBS") component of the Handbook.[58] Lastly, December 31, 2012 saw the implementation of the Retail Distribution Review ("RDR"), which is this Article's focus and which bans payment of commission to intermediaries. Accordingly, in twenty-five years, from the beginning of 1988 to the end of 2012, there have been some six significant regulatory phases for investment firms.

G. The Regulatory Regime Under FSMA

In the FSA's Handbook of rules and guidance, made under FSMA, the following propositions are relevant. First, the FSA Principles for Businesses—PRIN 2.1.1R—Principle 6 states: "A *firm* must pay due regard to the interests of its *customers* and treat them fairly."[59] Secondly, FSA Principle 8 states: "A *firm* must manage conflicts of interest fairly, both between itself and its *customers* and between a *customer* and another *client*."[60] It should be noted that while these Principles are FSA rules, they are, exceptionally, not actionable by private persons under FSMA section 150.[61] The most relevant component to investment business, including life insurance business, is COBS.

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[57] FIN. SERVS. AUTH., CONSULTATION PAPER 05/10, REVIEWING THE FSA HANDBOOK: MONEY LAUNDERING, APPROVED PERSONS, TRAINING AND COMPETENCE, AND CONDUCT OF BUSINESS 1–9, 37–45, Annex 5 (2005).

[58] *See* Directive 2006/31, art. 1, 2006 O.J. (L 114) (EC) (extending the time limit for the implementation of MiFID).

[59] FIN. SERVS. AUTH., PRINCIPLES FOR BUSINESSES ¶ 2.1.1 (2013).

[60] *Id.*

[61] *See id.* ¶ 3.4.4.

H. The FSA Handbook Pre-RDR

At a general level, COBS 2.1.1R, which implements article 19(1) of MiFID, provided: "(1) A *firm* must act honestly, fairly and professionally in accordance with the best interests of its *client* (the *client's best interests rule*)."[62]

More specifically, COBS 2.3.1R, which implements article 26(1) of the MiFID Implementing Directive, provided:

> A *firm* must not pay or accept any fee or commission, or provide or receive any non-monetary benefit, in relation to *designated investment business* . . . other than:
> (1) a fee, commission or non-monetary benefit paid or provided to or by the *client* or a *person* on behalf of the *client*; or
> (2) a fee, commission or non-monetary benefit paid or provided to or by a third party or a *person* acting on behalf of a third party, if:
> (a) the payment of the fee or commission, or the provision of the non-monetary benefit does not impair compliance with the *firm's* duty to act in the best interests of the *client*; and
> (b) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, is clearly disclosed to the *client*, in a manner that is comprehensive, accurate and understandable, before the provision of the service . . . or
> (3) proper fees which enable or are necessary for the provision of *designated investment business* or *ancillary services*, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot give rise to conflicts with the *firm's* duties to act honestly, fairly and professionally in accordance with the best interests of its *clients*.[63]

COBS 2.3 contained a more stringent regime on inducements and indirect benefits than any previous regulatory regime. Prior to 2007, the regulators were generally content to say that firms should consider the implications of general fiduciary law. In contrast, COBS 2.3 required full disclosure of third-party commission payments. It is also provided that any fee, commission, or non-monetary benefit paid or provided to or by a third party "must be designed to enhance the quality of the

[62] *Id.* ¶ 2.1.1.
[63] *Id.* ¶ 2.3.1.

relevant service to the client."[64] In accordance with guidance from the Committee of European Securities Regulators ("CESR"), a firm was able to comply with its obligations on inducements so long as it disclosed the essential arrangements relating to any fee, commission, or non-monetary benefit in summary form, and undertook to give further disclosure on request, and honored that undertaking. The regime was also extended by the FSA to packaged investment products which fall outside the scope of MiFID.

Senior Management Arrangements, Systems and Controls ("SYSC"), in chapter ten of the FSA handbook, includes material on conflicts of interest, which in a previous incarnation formed part of the old COB. SYSC 10.1.3R, which implements article 18(1) of MiFID, provided:

> A *firm* must take all reasonable steps to identify conflicts of interest between:
> (1) the *firm*, including its managers, employees and *appointed representatives* (or where applicable, *tied agents*), or any *person* directly or indirectly linked to them by *control*, and a *client* of the *firm*; or
> (2) one *client* of the *firm* and another *client*; that arise or may arise in the course of the *firm* providing any service referred to in SYSC 10.1.1 R.[65]

Furthermore, SYSC 10.1.4R, which implements article 21(1) of MiFID Implementing Directive stated:

> For the purposes of identifying the types of conflict of interest that arise, or may arise, in the course of providing a service and whose existence may entail a material risk of damage to the interests of a *client*, a *common platform firm* and a *management company* must take into account, as a minimum, whether the *firm* or a *relevant person*, or a *person* directly or indirectly linked by *control* to the *firm*:
> (1) is likely to make a financial gain, or avoid a financial loss, at the expense of the *client*;

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[64] THE COMM. OF EUROPEAN SEC. REGULATIONS, INDUCEMENTS UNDER MIFID: RECOMMENDATIONS ¶ 13 (2007) (based on MiFID Implementing Directive, Commission Directive, 2006/73, art 26(b)(ii), 2006 O.J. (L.241) 26 (EC), fleshing out MiFID, Directive 2004/39, art 19(1), 2004 O.J. (L 145) 1 (EC)).

[65] FIN. SERVS. AUTH., SENIOR MANAGEMENT ARRANGEMENTS, SYSTEMS AND CONTROLS ¶ 10.1.3 (2013).

(2) has an interest in the outcome of a service provided to the *client* or of a transaction carried out on behalf of the *client*, which is distinct from the *client's* interest in that outcome.[66]

II. THE RETAIL DISTRIBUTION REVIEW

A. *The RDR Discussion Paper*

In June 2007, the principal Discussion Paper on the RDR was published[67] and it was originally intended to provide full feedback in October 2008. However, in August 2008,[68] at the height of the financial crisis, the FSA announced that it would be November 2008 before any full feedback statement would be published, principally in the wake of the appointment of Jon Pain as Managing Director of Retail Markets at the FSA. The original Discussion Paper attracted some 888 responses and obviously prompted some significant further thinking at the FSA, as evidenced by an Interim Report.[69]

The original Discussion Paper pointed out that, although the retail investment sector had been regulated for two decades, numerous features of the industry—complex charging structures, heavy reliance on commission-based advisers, poor quality advice going undetected for many years, and limited training of advisers—suggested an inefficient market. It favored, effectively, a class-based system of "professional financial planning" for high-income consumers and more basic "primary advice" for the rest.[70] The latter regime might include a watering-down of the suitability regime.[71] It was not difficult to foresee that both European standards required by MiFID and other Directives, not to say the common law standard of care, might pose obstacles for this project.[72]

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[66] *Id.* ¶ 10.1.4.

[67] FIN. SERVS. AUTH., DISCUSSION PAPER 07/1: A REVIEW OF RETAIL DISTRIBUTION (2007) [hereinafter REVIEW OF RETAIL DISTRIBUTION].

[68] Press Release, Fin. Servs. Auth. (U.K.), FSA Announces Change to RDR Timetable (Aug. 7, 2008), *available at* http://www.fsa.gov.uk/library/communication/pr/2008/088.shtml.

[69] FIN. SERVS. AUTH., RETAIL DISTRIBUTION REVIEW—INTERIM REPORT ¶ 2–4 (2008) [hereinafter INTERIM REPORT].

[70] REVIEW OF RETAIL DISTRIBUTION, *supra* note 67, ¶ 20.

[71] *Id.* ¶ 22.

[72] *Id.* ¶¶ 5.32–.35.

B. RDR Interim Report

In April 2008, in the Interim Report,[73] perhaps driven by the relatively large consultative response—presumably industry-led—the FSA conceded that there was a consensus among respondents that its original proposals were too complex. And it appeared sympathetic to consultees' calls for a "simpler landscape" with a clear distinction between "advice" and "sales."[74] It now favored only one species of adviser, coupled with a "step-change in the standards required of advisers."[75] All would be independent, whole of market advisers whose remuneration was set without product provider input. Professional or educational standards would be increased. In contrast, "sales" would be strictly non-advised, in the form of either execution-only or guided sales in the context of wider government initiatives to promote more saving and investment. Again it was easy to foresee significant obstacles ahead of this anticipated terrain, from both European and domestic legal constraints. Furthermore, the long-standing lack of clarity in the consumer financial services context between giving advice and providing information does not look capable of swift resolution,[76] and the widespread incidence of supposedly "execution-only" transactions in the earlier pensions and endowment mis-sales episodes should not be forgotten. In addition, in this Interim Report, as a first step, the FSA exhorts product providers to drop out of their traditional role of remunerating advisers, and regulated firms generally are prodded in the direction of common professional standards.

C. The FSA Feedback: The Death Knell for Commission-Driven Sales

In November 2008, the FSA eventually provided its feedback and mapped out the future, in which the RDR spawned the "Retail Distribution Implementation Programme" ("RDIP"), rolling forward to the end of 2012.[77] A clearer distinction will be

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[73] INTERIM REPORT, *supra* note 69.

[74] *Id.* ¶ 5 (internal quotation marks omitted).

[75] *Id.*

[76] *Id.* ¶ 4.9.

[77] FIN. SERVS. AUTH., FEEDBACK STATEMENT 08/6, RETAIL DISTRIBUTION REVIEW—INCLUDING FEEDBACK ON DP07/1 AND THE INTERIM REPORT ¶ 17 (2008).

drawn between "independent advice" and "sales advice."[78] However, any attempt to draw a clear distinction between sales and advice has been dropped following discussions with the European Commission that confirmed that the proposed simpler landscape proposal would be inconsistent with MiFID.[79] Crucially, product providers were to be removed from a role in intermediary remuneration. This was the death knell of commission-driven (mis)sales. In the words of Jon Pain: "This is the end of the potential for commission bias."[80] Dan Waters, the FSA's Director of Retail Policy and Conduct Risk, was even more emphatic: "[T]hese rules will bring to an end the current practice in the UK of product providers offering adviser firms amounts of commission for selling their products."[81]

D. Implementing the RDR

At the end of June 2009, the FSA published its consultation paper on delivering the RDR, including draft *Handbook* text.[82] Despite the proclaimed commitment to greater clarity in the way in which firms describe their services to consumers, the FSA itself—having flirted with suggested distinctions between "professional financial planning" and "primary advice," "advice" and "sales," and "independent advice" and "sales advice"—eventually settled upon "independent advice" and "restricted advice."[83] Long-standing observers of the retail investment industry may detect a hint of "repolarization" after "polarization" and "depolarization." Crucially, all investment advice firms must set their own charges, with product providers being banned from offering commission to secure sales.[84] The intended scope of the new regime embraces not just the traditional "packaged products" but also unregulated collective investment schemes, all

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[78] *Id.* ¶ 3.9.

[79] *Id.* ¶ 13.

[80] Jon Pain, Managing Dir. of Retail Mkts., Fin. Servs. Auth. (U.K.), Speech at the FSA Distribution Review Seminar, Edinburgh: The Retail Distribution Review—The Key to Our Retail Strategy (Jan. 15, 2009).

[81] Dan Waters, Dir. of Retail Policy & Conduct Risk, Fin. Servs. Auth. (U.K.), Speech at ABI Conference: The Retail Distribution Review—Practical Challenges for the Investment Industry (Jan. 16, 2009).

[82] FIN. SERVS. AUTH., CONSULTATION PAPER 09/18, DISTRIBUTION OF RETAIL INVESTMENTS: DELIVERING THE RDR (2009).

[83] *Id.* at chs. 2–3.

[84] *Id.* at ch. 4.

holdings in investment trusts, and structured investment products.[85] Consideration is also being given to rolling out the same approach for general insurance and mortgage products.[86]

E. COBS After the RDR

The principal new rules are found in COBS 6.1A for all firms providing advice to retail clients, that is, intermediaries. In particular, COBS 6.1A.4R provides:

> [A] *firm* must:
> (1) only be remunerated for the *personal recommendation* (and any other related services provided by the *firm*) by *adviser charges*; and
> (2) not solicit or accept (and ensure that none of its *associates* solicits or accepts) any other commissions, remuneration or benefit of any kind in relation to the *personal recommendation* or any other related service, regardless of whether it intends to refund the payments or pass the benefits on to the *retail client*; and
> (3) not solicit or accept (and ensure that none of its *associates* solicits or accepts) *adviser charges* in relation to the *retail client's retail investment product* which are paid out or advanced by another party over a materially different time period, or on a materially different basis, from that in or on which the *adviser charges* are recovered from the *retail client*.[87]

COBS 6.1B.5R then bans providers and platforms from making such payments:

> [A] *firm* must not offer or pay (and must ensure that none of its *associates* offers or pays) any commissions, remuneration or benefit of any kind to another *firm*, or to any other third party for the benefit of that *firm*, in relation to a *personal recommendation* (or any related services), except those that facilitate the payment of *adviser charges* from a *retail client's* investments in accordance with this section.[88]

Lastly, from December 31, 2012, COBS 2.3.1R(2)(c) extended to general insurance business, meaning non-life business, a rule that a payment to or benefits conferred upon an intermediary by an insurer must "enhance the quality of the service provided to

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85 *Id.* ¶ 1.5.
86 *Id.* ¶ 1.7 & ch. 6.
87 CONDUCT OF BUSINESS SOURCE BOOK, *supra* note 4, ¶ 6.1.A.4.
88 *Id.* ¶ 6.1.B.5.

the client," in addition to the existing "best interests" rule.[89] New guidance at COBS 2.3.16A G suggests that an agreement may break rules if it provides a key source of income for a distributor.

F. The Regulator Flexes Its Muscles

In the run-up to implementation of the RDR, on October 1, 2012, a senior regulator from the FSA—the Head of the Life Insurance Department, Conduct Business Unit—wrote to the CEOs of the largest providers of retail investment products and largest distributors. These providers included life insurers, large independent financial intermediary firms, and networks of independent financial advisers. The letter announced: "We are concerned that some firms may be looking for ways to circumvent the adviser charging rules by soliciting or providing payments that do not look like traditional commission, but are generally intended to achieve the same outcome."[90] It lamented that such arrangements were "not in the spirit of the RDR."[91] Such arrangements are to be found in the intermediary contracts or "distribution agreements" between provider firms and distributor firms—that is, client-facing advisory firms.[92] The FSA renewed its threat to supervise heavily in an attempt to detect attempted circumventions of the new regime. The FSA formally sought confirmation that all distribution agreements of the targeted firms complied with the existing COBS 2.3 and the incoming new rules, COBS 6.1A, for all firms providing advice to retail clients, and COBS 6.1B, for providers and platforms, together with other, unpublished information.

The FSA instanced three examples of inducements which caused it concern: first, contributions by provider firms to the costs of a distributor firm's training or conference events, including lavish social benefits unrelated to training—no more cakes and ale; second, payments by a provider to a distributor for "assistance" with promoting the provider's products—these payments had to reflect the actual costs incurred by the

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[89] *Id.* ¶ 2.3.1(2)(c).

[90] Letter from Nick Poyntz-Wright, Head of Life Insurance Department, Conduct Business Unit, Fin. Servs. Auth. (U.K.), to the CEOs of a Sample of Life Insurers and Networks/IFAs (Oct. 1, 2012), *available at* http://www.fsa.gov.uk/static/pubs/guidance/rdr-inducements-rules.pdf.

[91] *Id.*

[92] *Id.* (internal quotation marks omitted).

distributor firm in promoting the services; third, payments to a distributor to update IT hardware and software. The FSA had had sight of five-year agreements providing IT support with sizeable payments being made in advance of December 31, 2012. These practices could offend the existing regime by encouraging a breach of the "best interests" rule, especially where the payments constitute a significant source of income for the distributor and might involve a breach of the rules requiring disclosure to clients of permitted inducements.[93] In addition, such practices could breach the new regime under COBS 6.1A, for all firms providing advice to retail clients, and COBS 6.1B, for providers and platforms. Large up-front payments on the eve of the RDR might be apportioned across the length of the distribution contract.

III. U.K. FIDUCIARY LAW

A. *Who Is a Fiduciary Under English Law?*

The law governing fiduciaries under English law pre-dates and co-exists with the regulatory law described above. Much of the remuneration of financial intermediaries, who were notionally the agents of the investor and therefore owed them fiduciary duties, was difficult to reconcile with equitable principles. The core requirement for the recognition of a fiduciary obligation is an assumption of responsibility for the property or affairs of another. The paradigm of the disinterested management of the affairs of another is the prime example of fiduciary responsibility, the trustee.[94] In addition, the agent constituted another status-based example of the fiduciary regime.[95] In the leading modern English authority of *Bristol & West Building Society v. Mothew*,[96] Lord Justice Millett stated:

> It is obvious that not every breach of duty by a fiduciary is a breach of fiduciary duty . . . [b]reach of fiduciary obligation, therefore, connotes disloyalty or infidelity. Mere incompetence

[93] CONDUCT OF BUSINESS SOURCE BOOK, *supra* note 4, ¶ 2.3.9.

[94] The seminal case is Keech v. Sandford, (1726) 25 Eng. Rep. 223.

[95] Logicrose Ltd. v. Southend United Football Club Ltd., [1988] 1 W.L.R. 1256 (Eng.).

[96] [1998] Ch. 1 (Eng.).

> is not enough. A servant who loyally does his incompetent best for his master is not unfaithful and is not guilty of a breach of fiduciary duty.[97]

It is only the second type of duty, that of loyalty, which is the true fiduciary obligation. As Lord Justice Millett observed in *Bristol & West Building Society*:[98]

> A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary.[99]

If the core obligation of the fiduciary is loyalty, a paradigm of breach of fiduciary duty is non-disclosure. The relationship between a fiduciary and his or her principal is one of the two main exceptions in English law to the rule that, in contractual transactions, there is no general duty to disclose material facts. As a general rule, if the fiduciary makes full disclosure of all the circumstances surrounding a transaction to the principal and the principal gives informed consent to the dealings by the fiduciary, a transaction will stand.

B. The Obligations of the Fiduciary

The obligations of the fiduciary stemming from the core principle of loyalty are multi-faceted, as recognized by Lord Justice Millett in *Bristol & West Building Society*:[100]

> This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary.[101]

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[97] *Id.* at 16, 18.

[98] *Id.* at 18.

[99] *Id.*

[100] *Id.* (followed in a Singapore case, Ng Eng Ghee v. Mamata Kapildev Dave, [2009] 3 S.L.R. 109 [135]).

[101] *Bristol*, [1998] Ch. 1 at 16.

In the context of financial services, the payment and receipt of wholly secret commissions to a fiduciary is a clear breach of the principle of loyalty. Equity deploys a very full armory of remedies against both the recipient of a bribe or secret commission and the payor of the bribe.

In the context of financial services, it has recently been a regulatory requirement to disclose the receipt of commission, as discussed above. In any event, equity has always maintained a stringent prohibition of the practice of secret commissions. The motive of the fiduciary is irrelevant. It is conclusively presumed that he has acted corruptly. The only defense is if it can be shown that the payment was made with the full, informed consent of the principal.

C. Remedies for Receipt of Secret Commissions

The following remedies are available to the principal in cases concerning the receipt of a bribe or secret commission. First, any contract of employment between principal and agent may be terminated.[102] Second, both the fiduciary and the third party paying the bribe or secret commission are jointly liable for damages in fraud, in the same measure as in the tort of deceit.[103] The damages will be at least the amount of the secret commission, but if the principal can prove additional loss—for example, paying too much or receiving too little under the resulting contract with the payor of the secret commission—that too can be recovered. Third, the principal may rescind any contract which resulted between himself and this third party.[104] Fourth, the principal can claim the amount of the bribe or secret commission as money had and received from the fiduciary[105] and also from the briber.[106] Fifth, the legitimate commission paid by the principal to the fiduciary will be forfeited.[107]

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[102] Bos. Deep Sea Fishing & Ice Co. v. Ansell, (1888) 39 Ch.D. 339, 357–58 (Eng.).

[103] Logicrose Ltd. v. Southend United Football Club Ltd., [1988] 1 W.L.R. 1256, 1263–64 (Eng.).

[104] *Id.* at 1260.

[105] Lister & Co v. Stubbs, (1890) 45 Ch.D. 1, 6 (Eng.).

[106] Arab Monetary Fund v. Hashim, [1993] 1 Lloyd's Rep. 543, 564–45 (Eng.).

[107] Imageview Mgmt. Ltd. v. Jack, [2009] EWCA (Civ) 63 [22] (Eng.) (citing *Ansell*, 39 Ch.D. at 353; Andrews v. Ramsay & Co., [1903] 2 K.B. 635, 637–38 (U.K.); and Rhodes v. Macalister [1923] 29 Com. Cas. 19, 25 (Eng.).

Lastly, at one point, it appeared to be accepted in English law that a personal claim in money had and received may be reinforced by a proprietary claim on the basis of a constructive trust, at least against the fiduciary.[108] However, in 2011 the Court of Appeal decisively insisted that the claim was purely personal and not proprietary.[109]

Not all of the above remedies can be accumulated. The principal may recover the amount of the bribe or secret commission only once, from either the briber or the fiduciary. Furthermore, the principal must elect between a compensatory claim for fraud and a restitutionary claim for the amount of the bribe.[110] In the context of financial services, the availability of these various remedies for the payment of bribes and secret commissions has always been available in principle, although it does not appear to have been tested in the reported cases. It further seems clear that attempts to disclose the existence of a commission by referring to it in documentation may not be sufficient if this does not achieve the full, informed consent of the principal.[111]

D. Disgorgement of Commission and Other Secret Benefits

Financial advisers and insurance intermediaries are usually the agents of the customers and are therefore in a fiduciary relationship with them. Given that much business has generally been commission-driven, with the agent receiving often substantial financial benefits from a third party, it would appear to be a trite application of fiduciary law that an agent must either disclose the existence of the proposed commission arrangement in advance to the customer—his principal—or else be liable for a claim for disgorgement of that benefit by the customer. However, it is difficult to find a clear statement of this principle in the financial services context.

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[108] Attorney Gen. for H.K. v. Reid, [1994] 1 A.C. 324, 336 (P.C.) (appeal taken from N.Z.) (U.K.) (disapproving Lister & Co v. Stubbs, (1890) 45 Ch.D. 1, 15 (Eng.)).

[109] Sinclair Invs. (UK) Ltd. v. Versailles Trade Fin. Ltd., [2011] EWCA (Civ) 347, [72]–[73] (Eng.) (citing *Lister*, 45 Ch.D. at 15). But see generally FHR European Ventures LLP v. Mankarious, [2013] EWCA (Civ) 17 [33] (Eng.), especially the judgment of Sir Terence Etherton Chancellor.

[110] Mahesan S/O Thambiah v. Malay. Gov't Officers' Coop. Hous. Soc'y Ltd., [1979] A.C. 374, 382–83 (P.C.) (U.K.).

[111] For consideration of regulatory duties in respect of payment of commission, see discussion, *supra* Part II.E.

E. Application to Financial Intermediaries

One example of the stringency of the fiduciary requirement is *Seymour v. Ockwell*.[112] An independent financial adviser ("IFA") recommended an offshore fund of a company called Imperial Consolidated—a fraudulent investment scheme—which was held in an Allied Dunbar Isle of Man offshore life policy "wrapper bond" in the Isle of Man.[113] The IFA received £2,500 from Allied Dunbar, which was properly disclosed by the IFA to the investors in that case, and the claim in respect of that sum was dropped at trial.[114] However, in addition, Imperial Consolidated paid a "marketing allowance" of £4,850 to the IFA, of which the IFA was unaware at the time of the initial recommendation—albeit that the IFA became aware of it while the investment could have been reversed during the "cooling-off" period.[115] It was not disclosed until some four months after the transaction. His Honour Judge Havelock-Allen QC rejected a submission that the "marketing allowance" of £4,850 was not a commission: "Plainly this was a commission whatever label was attached to it."[116] It was further submitted that the payment fell outside the mischief covered by the then relevant FIMBRA rules,[117] which required such payments to be disclosed in writing before the client signed any proposal. It was accepted that the adviser could not disclose a payment of which she was unaware when the contract was signed. Nevertheless, His Honour Judge Havelock-Allen QC continued:

> But Mr McMeel [counsel for the investors] put the case more generally. In his submission a person (such as Miss Ockwell) who is under a fiduciary obligation must account to the person to whom the obligation is owed not only for any benefit or gain obtained or received in circumstances where a conflict of interest might exist but also for any benefit or gain obtained or

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[112] [2005] EWHC 1137 (Q.B.) (U.K.). For the benefits obtained by the Zurich broker consultant of a "free week's holiday in New Orleans" as a result of the investment, see *id.* [57], and the judge's comments, see *id.* [73].

[113] *Id.* [20].

[114] *Id.* [186].

[115] *Id.*

[116] *Id.* [188].

[117] Pers. Inv. Auth., PIA Rulebook, ch. 12, Rule F29.9, *available at* http://hb.betterregulation.com/external/PIAA%20%7C%20Chapter%2012%20of%20the%20PIA%20Rulebook.pdf (material interests and conflicts of interest); *id.* Rule F29.10 (disclosing commission).

> received by reason of his fiduciary position. Even if there was no conflict of interest, because Miss Ockwell did not know of, and ex hypothesi could not have been influenced by, the marketing allowance, the allowance was remuneration obtained by reason of her position as the claimants' financial advisor. She is liable to account for it and she can only keep it if it was promptly disclosed and Mr and Mrs Seymour have expressly or by implication consented to her keeping it. I think that this submission is correct.[118]

As a matter of fact the allowance was not promptly disclosed and it was not argued that the customer had consented. If necessary, the judge would have held it was earned in circumstances in which there was the possibility of a conflict of interest, because the adviser learned of it during the cancellation period when Mr. and Mrs. Seymour were seeking reassurance about the wisdom of the investment. It should have been disclosed before making further recommendations to continue with the contract.[119] This case is probably the clearest illustration of the application of fiduciary law in this context. Obviously, it concerned the liability of the fiduciary agent and not the paying fund, which was hopelessly insolvent.

F. What Is a Bribe?

What makes a secret commission a bribe? Essentially, a corrupt purpose does. In *Anangel Atlas Compania Naviera S.A. v. Ishikawagima-Ahrima Heavy Industries Co. Ltd.*,[120] Mr. Justice Leggatt said: "[I]t may be said that a bribe consists in a commission or other inducement which, is given by a third party to an agent as such, and which is secret from his principal."[121] According to Lord Justice Romer in *Hovenden & Sons v. Millhoff*,

> If a gift be made to a confidential agent with the view of inducing the agent to act in favour of the donor in relation to transactions between the donor and the agent's principal and that gift is secret as between the donor and the agent—that is to say, without the knowledge and consent of the principal—then the gift is a bribe in the view of the law.[122]

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[118] *Seymour*, [2005] EWHC [188].
[119] *Id.* [189].
[120] [1990] 1 Lloyd's Rep. 167 (Q.B.) (Eng.).
[121] *Id.* at 171.
[122] [1900] All E.R. Rep. 848 (Eng.).

G. Two Categories of Commission Payments: "Wholly Secret" Commissions and Inadequate Disclosure

A highly significant decision of the Court of Appeal in 2007 has further developed the rules on commissions paid to agents in the related context of regulated consumer credit agreements, and in particular, what appears to have a "sub-prime," non-status loan arranged through a credit broker. In *Hurstanger Ltd. v. Wilson*,[123] the Court of Appeal distinguished two new sub-categories of commissions paid to agents by third parties: first, "wholly secret" commissions; and, second, cases of limited but inadequate disclosure.[124]

The defendants, a co-habiting couple, were in arrears with their mortgage and sought a further loan of £8,000 through a local credit broker, Mr. Dunk, who was trading as One Way Finance.[125] The aim was to pay off arrears of £5,500 under the mortgage, reimburse the broker his £1,000 fee, with the modest balance left to provide surplus funds for the couple.[126] The loan was ultimately provided by the claimant lender.[127] One of a number of documents which the couple signed included the statement: "The broker who assisted us in making this loan application is acting as our agent and is not tied in any way whatsoever to the company [the lender]. In certain circumstances this company does pay commission to brokers/agents."[128] When the loan was made, in addition to the agreed £1,000 fee, the lender also paid the broker a commission of £240.[129] Evidence was given on behalf of the lender that the tertiary or non-status lending market was highly competitive and that it had become necessary for small lenders to pay commissions to brokers to attract business.[130] The recorder found that there was nothing unusual about the circumstances surrounding the payment of the commission or its amount, three percent of the loan.[131] He rejected a submission that the loan was

[123] Hurstanger Ltd. v. Wilson, [2007] EWCA (Civ) 299 (Eng.).

[124] *Id.* [38]–[39]; *see also* FHR European Ventures LLP v. Mankarious, [2013] EWHC (Civ) 17 (Eng.).

[125] *Wilson*, [2007] EWCA (Civ) [2].

[126] *Id.*

[127] *Id.* [5].

[128] *Id.* [4].

[129] *Id.* [5].

[130] *Id.* [30].

[131] *Id.* [31].

void by reason of payment of a secret commission.[132] Both parties appealed based on aspects of the Consumer Credit Act 1974 regime, which are not relevant, and the defendants sought leave to appeal in respect of the commission issue.

Lord Justice Tuckey gave the only reasoned judgment in the Court of Appeal. Lord Justices Waller and Jacob agreed. Permission to appeal was granted at the start of the hearing on the secret commission issue. Lord Justice Tuckey observed:

> The defendants retained the broker to act as their agent for a substantial fee. The contract of retainer contained the usual implied terms, but the relationship created was obviously a fiduciary one. As a fiduciary the agent was required to act loyally for the defendants and not put himself into a position where he had a conflict of interest. Yet he agreed that he would be paid a commission by the other party to the transaction which his clients had retained him to procure. By doing so he obviously put himself into a position where he had a conflict of interest. The defendants were entitled to expect him to get them the best possible deal, but the broker's interest in obtaining a further commission for himself from the lender gave him an incentive to look for the lender who would give him the biggest commission.[133]

The law as laid down by the Court of Appeal can be described in a number of propositions. First, where an agent receives commission from a third party without the informed consent of his principal, he, the agent, is in breach of fiduciary duty. Second, informed consent means consent with full knowledge of all the material circumstances and of the nature and extent of the agent's interest. Third, the third party, here the lender, who pays the commission is an accessory to the breach and is liable as such. Fourth, whether there had been sufficient disclosure to secure the principal's consent is a question of fact in each case, bearing in mind that what is required is informed consent to the agent acting despite a potential conflict of interest. Fifth, the burden of proving full disclosure lies on the agent, or in appropriate cases, the third party. Sixth, it is generally not sufficient for the agent to state that he has an interest or to make a statement which would merely put the principal on inquiry. Seventh, it is no defense to

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[132] *Id.*
[133] *Id.* [33].

prove that had the agent asked for the principal's consent it would have been given.[134] Eighth, where the principal was likely to be vulnerable and unsophisticated, the duty of disclosure extended to disclosure of the actual amount of commission he was to receive.[135]

Ninth, there are two categories of cases: (a) Where there had been no disclosure at all, receipt of a secret commission, or bribe, was a blatant breach of fiduciary duty and amounted to a special category of fraud in which it is unnecessary to prove motive, inducement, or loss up to the amount of the bribe. The principal has alternative remedies against both briber and agent for money had and received in the amount of the bribe or damages for fraud in respect of the actual loss sustained.[136] In addition, the transaction between briber and principal is voidable at the election of the principal, provided counter-restitution can be made.[137] (b) There was also a "half-way house" between full disclosure and secrecy: where there is partial or inadequate disclosure, which is sufficient to negate secrecy. The second category is where there has been some disclosure, but it is inadequate in failing to disclose the amount or to make it clear that the principal is being asked to consent. Nevertheless, in such cases there is a breach of fiduciary duty, but the defendants "are not entitled to deploy the full armoury of remedies which would have been available if this had been a true secret commission case."[138]

Tenth, the court has discretion whether or not to grant rescission.[139] Eleventh, the principal has a claim against the third party who procured the breach of fiduciary duty for equitable compensation in the amount of the bribe, which mirrors the common law right to claim the return of the bribe as

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[134] The first seven propositions in paragraphs 34 and 35 of the judgment draw heavily on BOWSTEAD & REYNOLDS ON AGENCY ¶¶ 6-055–57 (William Bowstead & F.M.B. Reynolds eds., 18th ed. 2006).

[135] *Wilson*, [2007] EWCA (Civ) [36] (glossing the more tentative statement in BOWSTEAD & REYNOLDS ON AGENCY, *supra* note 134, ¶ 6-084).

[136] *Wilson*, [2007] EWCA (Civ) [37] (citing Mahesan S/O Thambiah v. Malay. Gov't Officers' Coop. Hous. Soc'y Ltd., [1979] A.C. 374, 383 (P.C.) (U.K.)).

[137] *Id.* (citing Pan. & S. Pac. Tel. Co. v. India Rubber, Gutta Percha & Tel. Works Co., (1875) 10 Ch. App. 515, 527, 532–33 (Eng.)).

[138] *Id.* [44].

[139] *Id.* [45] (citing Johnson v. EBS Pensioner Trs. Ltd., [2002] EWCA (Civ) 164 [74] (Eng.)).

money had and received.[140] Twelfth, where the award of equitable compensation was adequate to compensate the principal fully, it would usually have been unfair and disproportionate to rescind the contract between third party and principal, notwithstanding questions of counter-restitution.[141]

Lord Justice Tuckey made clear what was required in this particular context: "Borrowers like the defendants coming to the non-status lending market are likely to be vulnerable and unsophisticated. A statement of the amount which their broker is to receive from the lender is, I think, necessary to bring home to such borrowers the potential conflict of interest."[142]

Here, there had been sufficient disclosure, through the signed documents, to negate secrecy. However, it was inadequate in failing to disclose the amount or to make it clear that the principal was being asked to consent, in circumstances where the broker was not in a position to give unbiased advice. Accordingly, informed consent had not been given.[143] On the facts of the instant case, the lender, which had paid the commission, was guilty of procuring the agent's breach of fiduciary duty and was ordered to pay equitable compensation in the amount of the commission, namely £240 plus interest.[144] However, it was held that it would be unfair and disproportionate to order rescission of the resulting loan.[145]

Where an independent financial adviser or other agent or broker owes fiduciary duties to a customer, *Hurstanger Ltd. v. Wilson* makes it clear that the obligation of full disclosure of commissions and other payments may be an extensive one. It is critical that some kind of warning of the potential conflict, which the proposed, payment poses for the agent, is spelled out in appropriate cases, and that the need for the principal to give consent is made clear, and presumably that the principal has a choice. The case leaves room for potential differentiation of different classes of customer, with potentially sophisticated investors or market counterparties requiring only brief disclosure of commission but with a regime of full disclosure for at least

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[140] *Id.* [46].
[141] *Id.* [48].
[142] *Id.* [36].
[143] *Id.* [38].
[144] *Id.* [49].
[145] *Id.* [48].

vulnerable consumers, perhaps extending to all retail clients. *Hurstanger* also makes it clear that product providers and others who make the commission payments are equally in the frame, and in extreme cases, like of total secrecy, are subject to having the resulting transaction rescinded.

H. Application to Sophisticated Investors

The situation is likely to be different if the investors are either high net worth individuals or sophisticated investors or both. Contrast the vulnerable, needy, sub-prime borrowers in *Hurstanger*. Such investors may be said to know that IFAs receive commission and often large sums of commission for their advice and services. This can be illustrated by a decision handed down in early 2012 by the Hong Kong Court of First Instance.

In *Hobbins v. Royal Skandia Life Assurance Ltd.*,[146] the plaintiff investor was a wealthy and successful businessman with a string of directorships and various overseas properties.[147] The first defendant was a life insurer and provider of life policy-based investment products.[148] The second defendant ("Clearwater") was an independent financial adviser and insurance broker.[149] Mr. Hobbins entered into a number of investments on the advice of Clearwater, which disclosed in writing from the outset that it would charge him no fees but that it would be remunerated by commissions payable by life insurers and product providers, such as Skandia.[150] Mr. Hobbins signed client agreements acknowledging this state of affairs.[151] Ultimately, Mr. Hobbins was dissatisfied with the performance of his Skandia investment following the global financial crisis and brought proceedings alleging fraud, conspiracy, and breaches of duty by Clearwater for which he alleged Skandia was responsible.[152] His claim was dismissed.[153]

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[146] Hobbins v. Royal Skandia Life Assurance Ltd., [2012] 1 H.K.L.R.D. 977 (C.F.I) (H.K.).
[147] *Id.* [8].
[148] *Id.* [1–3].
[149] *Id.*
[150] *Id.*
[151] *Id.* [16].
[152] *Id.* [3]–[6].
[153] *Id.* [138].

While the payment by commission was disclosed, the critical fact was that the *amount* of the commission was not. The allegations of fraud and conspiracy were groundless and Mr. Hobbins was ordered to pay the defendants' legal costs on the full or "indemnity" basis in accordance with the "English rule" of costs-shifting. Justice Reyes was unequivocal that Clearwater was Mr. Hobbins's agent, and not the agent of Skandia, as the agreement between Skandia and Clearwater made clear, and there was no allegation of ostensible or apparent authority.[154] The judge rejected an argument that the payment involved an illegal and criminal violation of the Hong Kong Prevention of Bribery Ordinance.[155] Justice Reyes was clear that there was "lawful authority" for the payments based on a century of English common law authority that commission paid to an insurance broker by the insured "does not constitute an illegal secret profit unless it is in excess of what is normally paid within the insurance market."[156] Interestingly, it was argued that the Hong Kong Prevention of Bribery Ordinance had changed the common law when enacted in 1971 and that the recent developments in the U.K. under the RDR and in Australia under the Corporations Amendment (Further Future of Financial Advice Measures) Act 2011 were only just catching up with the law in Hong Kong. That submission was emphatically rejected. Nothing in the text or background of the legislation supported the submission: "One would not expect the legislature to overturn a long line of case law in a highly oblique and casual manner."[157]

Justice Reyes distinguished the Canadian Supreme Court case of *R v. Kelly*[158] and appeared in any event to prefer the reasoning of Justice McLachlin, who did not consider the disclosure of the amount of commission, to the reasoning of Justice Cory, who had insisted on the full disclosure of the nature, amount, and source of commission payments in the criminal context. In that case, a financial planner sold residential units and was rewarded by both purchasers and the

[154] *Id.* [58]–[60].

[155] Prevention of Bribery Ordinance, (2005) Cap. 201, § 17 (H.K.); *Hobbins*, 1 H.K.L.R.D. [75]–]76].

[156] *Hobbins*, 1 H.K.L.R.D. [79]–[80] (internal quotation marks omitted).

[157] *Id.* [86].

[158] [1992] S.C.R. 170 (Can.).

vendor, but there had only been vague references to "costs" in the extensive documentation.[159] Justice Reyes was able to distinguish the case as one where there was no meaningful, unequivocal disclosure that any commission was being paid at all. There was passing reference to, but no analysis of, *Hurstanger Ltd. v. Wilson*. It is noteworthy that Justice Reyes commented: "The practice of insurers paying commission to insurance brokers may or may not be unsound. It ought possibly to be strictly regulated or even prohibited altogether. I express no view on the matter. That is a question of policy best left to the legislature, not the Court, to tackle."[160]

CONCLUSION

Following years of financial product mis-selling on a vast scale and huge levels of consumer detriment—and the consequential massive cost to banks and financial institutions in handling consumer complaints and paying compensation—the U.K. financial regulatory system has finally determined that commission-driven incentives to intermediaries are at the root of the problem. Over the course of a decade, the U.K. has moved from having no regulatory rules on disclosure, to a disclosure regime and has now decisively embraced a complete ban on the payment and receipt of commission in the retail investment context. It remains to be seen how this new regime, in place from the start of 2013, improves the culture and practice of the provision of financial advice. A further concern must be the extent to which the intermediation channels and incentives for advisers will continue to exist in a purely fee-based remuneration world. Will investors be willing to pay for investment advice? Will the U.K. market in retail investment, savings, and life insurance hold up? Will financial advice and products reach the people who need it? The outcomes of the U.K.'s prohibition on commission-rewarded advice will be watched with interest in other jurisdictions.

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[159] *Id.*

[160] *Hobbins*, 1 H.K.L.R.D [89].