

*The Consumer of a Banking and/or
Financial Contract as the Weak Party and his
Protection under Statute*

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A starting question

Do you believe - when negotiating with a bank as a potential future investor – you will be able to understand the risks associated with the investment and, basically, to protect your position by yourself?

Themes and questions to be discussed

- Freedom of Contract, as the main paradigm of Contract Law, vs. Legal Protection and the emerged need for protecting the weaker contractual party
- The typical protective rules in EU legislation relating to general contracts
- The Bank – Client Relationship and its non - statutory regime
- The Investment Firm - Client Relationship: if and how to protect investors
 - In particular: the “Mifid”: a retail investor special protection regime

Freedom of Contract vs. Legal protection

- The rationales for the traditional model of contract: “*laissez faire*”, “*caveat emptor*”, individual autonomy, competition mechanism
- The emerging need for protecting a particular class of individuals lacking of expertise, knowledge, skill: the “consumer”
- Striking a balance between freedom of economic activity and individual’s self determination: the EU approach

The Consumer and the typical protective rules in EU legislation relating to contracts

- The Consumer as any *natural person* who, in the contracts covered by a specific Act, is acting for purposes *which are not related to his trade, business or profession*
- The most common ways of protecting the consumer
 - Duties of information, and the “information model”
 - Duty of information and duty to advice
 - Mandatory provisions
 - Waivable/unwaivable statutory provisions. Criticism: paternalistic considerations
 - Right of Termination of contracts
 - Prevention of the use of unfair contract terms in contracts with businesses (see beyond)

Test of fairness

A term is unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations under the contract, to the detriment of consumers. 'Good faith' means that you must deal fairly and openly with consumers. Standard terms may be drafted to protect commercial needs but must also take account of the interests and rights of consumers by going no further than it is necessary to protect those legitimate commercial interests.

The plain language requirement. According to the Unfair Contract Terms Act Regulations (UTCCRs,) a standard term must be expressed in plain and intelligible language. A term is open to challenge if it could put the consumer at a disadvantage because **he or she is not clear about its meaning** - even if its meaning could be worked out by a lawyer. If there is doubt as to what a term means, the meaning most favourable to the consumer will apply.

What terms are not covered? Most standard terms are covered by the UTCCRs. The exceptions are those: - that reflect provisions which by law have to be included in contracts; that have been individually negotiated; in contracts between businesses; in contracts between private individuals; in certain contracts that people do not make as consumers – for example, relating to employment or setting up a business; in contracts entered into before 1995.

Terms setting the price or defining the product or service. Terms in consumer contracts which set the price or define the product or service being supplied are 'core terms' of the contract and are exempt from the test of fairness as long as they meet the plain language requirement.

Regulatory and non - regulatory regimes in the area of financial services

Regulatory regime:

- Private Law and its traditional leading role
 - General law of obligation and judge-made contract rules
 - General duties: d. of care and d. to act upon good faith
- The recent European securities regulation:
 - A) 1993 Investment Service Directive (ISD1)
 - Broadly formulated principles regulating the conduct of the investment firms
 - B) 2004 Market in Financial Instruments Directive (Mifid)
 - Detailed rules of conduct – the role of the Lamfalussy Architecture

Non – regulatory regime:

- Codes of conduct

Banks – Clients

non - regulatory regime

Under English Law there are no statutory provisions aimed at protecting the bank's clients. Yet, this does not mean that under English Law there is no protection at all for banks' customers. The protection of the weaker party is achieved by codes of conduct (i.e. rules which set a standard of good practice that apply on a voluntary basis, that is if the bank accepts to adopt that particular code). They do not provide binding rules, but the banks which submit to the code must respect those standards of conduct.

The Banking Code

The Banking Code was a voluntary code which set standards of good banking practice for financial institutions to follow when dealing with **personal customers** in the UK.

The Banking Code applied to:

- current accounts, including basic bank accounts;
- savings and deposit accounts;
- payment services, including foreign-exchange services;
- cards and pins;
- loans and overdrafts.

The Banking Code

The Banking Code was monitored and enforced by the Banking Code Standards Board.

The Code was sponsored by the Building Societies Association, British Bankers' Association and APACS (the UK payments association).

The latest version of the Banking Code was published in March 2008 following an independent review.

The Banking Code

The Banking Code was repealed once responsibility for regulating retail banking products moved to the Financial Services Authority and to the Lending Standards Board.

The Banking Code was withdrawn on 1 November 2009 and is no longer in force. It has been replaced by:

- the Banking Conduct of Business Sourcebook and Payment Services Regulations 2009 (enforced by the Financial Services Authority); and
- the Lending Code (enforced by the Lending Standards Board).

The Banking Conduct of Business Sourcebook

The FSA's Banking Conduct of Business Sourcebook (**BCOBS**) came into force on 1st November 2009. **It applies to firms carrying out the activity of accepting deposits from banking customers in the UK**, for example by providing saving and current accounts. BCOBS contains rules and guidance on:

- communications with banking customers and financial promotions;
- distance communications, including the requirements of the Distance Marketing Directive and E-commerce Directive;
- information to be communicated to banking customers, including appropriate information and statements of account;
- post sale requirements on prompt, efficient and fair service, moving accounts and lost and dormant accounts;
- unauthorised and incorrectly executed payments; and
- cancellation, including the right to cancel and the effects of cancellation.

The Banking Conduct of Business Sourcebook

BCOBS applies to accepting deposits to the extent that it does not overlap with the requirements of the Payment Services Regulations (PSRs) relating to payment transactions and payment accounts.

This means that, broadly:

- where a retail banking service is not a payment service within the scope of the PSRs, BCOBS applies in full;
- where a retail banking service is a payment service within the scope of the PSRs, parts of BCOBS would not apply.

The Lending Standard Board

The Lending Standards Board is an organisation taking over the Banking Code Standards Board. It began working on 2nd November 2009.

The LSB has a number of key objectives:

- To assist firms to interpret and meet the requirements of the Lending Code;
- To monitor and enforce compliance with the Code and to take enforcement action for material breach;
- To ensure subscribers provide a **fair deal** to their personal and micro-enterprise borrowing customers.
- To identify any gaps and deficiencies in the Code that could lead to consumer detriment and to advocate change.

The Lending Code

The Lending Code replaced the Banking Codes following the transfer of responsibilities for the conduct of business regulation for deposit and payment products to the FSA.

The Code protects the following borrowing customers

- a consumer;
- a micro-enterprise (that is a business which employs fewer than 10 persons and has a turnover or annual balance sheet that does not exceed € 2 million);
- a charity which has an annual income of less than £1 million.

The Lending Code

The Lending Code sets standards of good lending practice in relation to loans, credit cards and current account overdrafts. It does not apply to non-business borrowing secured on land or to sales finance.

The Code contains key commitments and detailed notes on how customers should be dealt with through the whole product life cycle, from marketing and account opening, maintenance and the provision of information on changes to terms and conditions and interest rates.

Important protection is also included to help when something goes wrong, including when someone is experiencing financial difficulties.

The Investment Firm - Client Relationship

If and how to protect investors

Main concepts and definitions

Financial services and investment services;

Investment firms and

- their role of intermediation for financial instruments, in primary and secondary markets, between issuers of financial instruments and investors;
- Their role of providers of valuable information.

1993 Investment Service Directive

Undifferentiated and principles-based protection system

The need for protection under ISD

- ISD explicitly stated the principle that investor protection must take into account the difference between professional and investors, but
- Did not contain any rules as to how clients has to be categorized

ISD principles of conduct

Article 11 of ISD:

- a) **loyalty principle:** any investment firm must act honestly and fairly in the best interests of its clients
- b) **informed consent p.:** the investment firm must adequately disclose relevant material information – on risks, costs, nature of the services etc. - when dealing with its clients
- c) **Know your customer p.”:** the investment firm must seek from its clients information regarding their financial situations, investment experience and objectives as regards the financial services requested

Mifid

*A differentiated and rules-based client
protection system*

The need for protection and the Mifid's differentiated client protection system

Mifid's new client categorization system and the “elevator” mechanism (“opting-up”; “opting-down”). Different needs for protection and the three categories of investors:

- Eligible counterparties
- Professional Clients
 - “*Per se*” professional
 - Elective professional
- Retail Clients
 - “*Per se*” retail clients
 - Elective retail clients

Professional clients

- “Per se” Professional Client (credit institutions, investment firms, pension funds, large undertakings, central banks, etc.) are those entities automatically considered to be professional clients;
- “Elective” professional clients (opting-up): investors that are normally considered to be retail clients but who opted out of the protection granted to retail clients. Consequently, waiving the protection given by the Mifid, they are treated as professional clients at their own request
 - On the necessary investment firm’s judgement of the adequate expertise, experience, knowledge of the investor
 - On the potential “reclassification” of the investor

Retail Clients “per se”

- Are the components of the class of clients who, not being a professional one or an eligible counterparty, deserve the maximum level of protection. As a consequence, a retail client is a client who is neither a professional client nor an eligible counterparty
- It includes natural persons as well as legal entities, and it does not matter the purpose the client acts for (note the difference with the consumer law)

“Elective” Retail Clients (opting-down)

- Are the components of the class of clients who, though being considered as professionals, have asked for the maximum level of protection
- Summing up:
 - Investors and consumers. Main differences

Main differences between the Mifid retail and professional client regimes

Level 1. Very few rules are differentiated according to the type of client. The investment firm must constantly act “honestly, fairly and professionally in accordance with the best interest of its clients”, therefore independently from their categorization.

Level 2. The following points are differentiated :

- information duties
- documenting and reporting duties
- order execution rules

The principles set out by Mifid and the crucial role of the loyalty to the client's interest

- Art. 19.1 (*Conduct of business obligations when providing investment services to clients*)
“Member States shall require that, when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in paragraphs 2 to 8”.
- In particular: the loyalty to the best interest of the client

Mifid conduct of business detailed rules

Art. 18 to 24 of the Mifid

- Duty to provide clear, faithful and not misleading information
 - E.g.: marketing communications have to be clearly identifiable as such
- Duty to know one's client
 - Each client has a personal financial situation and personal investment objectives
- Duty to ensure best execution of the client's order
 - When executing a client's order, the investment firm must obtain the best possible result, taking into account, mainly, prices, costs, timely executions etc.
- Duty to ensure the appropriateness or the suitability of an investment service, a financial instrument or an investment product to one's client (see beyond)

In particular: investors' protection and duty of information

- Retail investors' protection is one of the main objectives of the EC Directive on Markets in Financial.
- Therefore, MiFID imposes several information duties on securities firms, which can roughly be divided into
 - duties to provide information to the client and
 - duties to obtain information about the client and financial instruments offered ('know your customer', 'know your security').
- The common objective of all those duties is to enable retail clients to *'take investment decisions on an informed basis'*

The suitability test

When is the product/service suitable for the client?

- The client must be able to understand the risks
- The transaction must meet the investment objectives of the client
- The client must be able to bear the financial risks implied in the transaction

As a consequence, the firm must obtain information about the client concerning his relevant experience and knowledge, his financial situation and his investment objectives

Forthcoming novelties

Mifid II proposes the Authorities be entitled to

- ban dangerous products (e.g.: financial derivatives);
- require product providers to include certain product features;
- specify minimum product standards;
- prevent the sale of a particular product to certain types of investors

A Conclusion: ‘Freedom of Contract’ and New Needs of Protection

1. Freedom of Contract is no longer the sole paradigm of Contract Law, the other being the Protection of Weaker Contracting Party
2. In the future, new groups of weak parties may be given protection by the courts on the basis that the provisions in force bear witness to the existence of a general principle, which allows extensions to new groups