## KEY POINTS

- The EU Markets in Financial Instruments Directive ('MiFID') established regulatory obligations which are intended to be tailored to differing levels of investor sophistication.
- Those who invest as part of their business do not have a statutory right of action in respect of breaches of such obligations.
- The common law may regard sophistication as a 'pointer against' any duty of care arising.





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# Sophisticated investors: do they have any rights?

Contrary to some recent comments in the financial press, if an investor in Collateral Debt Obligations ('CDOs') is not a consumer it does not follow that he is necessarily treated as 'sophisticated'. But he is likely to find it difficult to establish that an investment bank owed him a duty of care.

## BACKGROUND

Collateral Debt Obligations ('CDOs') are generally recognised as complex forms of investment. Most of those who hold such instruments would be described by market participants as 'sophisticated investors'. Such investors might fairly be considered to accept the risk of defaults arising because the assets underlying the securities fail to perform, or because of adverse market forces. But what if the default arises because the investment bank which arranged the transaction was careless? Or what if, as alleged by the Securities & Exchange Commission in its recently settled complaint against Goldman Sachs, the arranger failed to make clear to investors that a party taking the opposite position to investors has been allowed to influence the structure of the transaction?

It might be unrealistic to expect an investor (even a sophisticated one) to spot carelessness or potential conflicts of interest when conducting its due diligence. The investor might, in practice, rely on the arranging bank to have performed its role with proper care. And some investors, such as pension funds or public sector entities, which are regarded as 'sophisticated', may not be well versed in the particular product being offered. Should the risk of defaults arising in such circumstances fall upon investors?

Recently, articles have appeared in the financial press criticising the notion that every investor who is not a consumer is classed as 'sophisticated' and accordingly deprived of legal protection. This feature considers how English law responds to claims by 'sophisticated investors' and whether the division into consumers and 'sophisticated investors' is as black and white as is sometimes suggested.

Broadly speaking, the 'sophistication' of an investor is relevant in two contexts in English law. The first relates to the *statutory regulation* of firms providing investment services, while the second concerns the duties owed by such firms to investors *at common law*. To an extent, the common law duties are informed by the regulatory position. The phrase 'sophisticated investor', however, is not a term of art in either the regulations or the common law. The expression seems to have originated in the US regulatory system and has become a convenient shorthand for a client who can understand the nature and risks of investments without needing a detailed explanation.

## 'SOPHISTICATION' WITHIN THE REGULATORY REGIME

The relevant regulatory regime is detailed and only a broad outline is attempted here. The word 'sophisticated' is not used, but clients are classified into essentially three groups: retail clients, professional clients and eligible counterparties.

The source of the current UK regulatory scheme is the Markets in Financial Instruments Directive 2004/39/EC ('MiFID'), which entered into force on 21 April 2004. This was supplemented on 10 August 2006 by the MiFID Implementing Directive 2006/73/EC. The principal provision in respect of which 'sophistication' is relevant is art 19 of MiFID, which imposes certain 'conduct of business obligations' on firms providing investment services to clients. In very simple terms, art 19(1) requires investment firms to observe the general duty to act 'honestly, fairly and professionally' and the remainder of art 19 sets out certain particular obligations arising out of that general duty. In respect of services which do not involve investment advice or portfolio management (which are subject to additional requirements) art 19(5) requires investment firms to 'ask the client or potential client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or services offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client'. If the firm considers that the services or products are not appropriate, it must give a warning to that effect.

At first blush this suggests a substantial level of protection afforded to clients, but the bank's obligations are significantly mitigated in two respects. First, art 24 excludes transactions with 'eligible counterparties' from the operation of art 19. Certain entities, including pension funds and certain public bodies, automatically qualify as eligible counterparties, while other entities can be recognised as eligible counterparties if certain thresholds are met.

Secondly, the effect of arts 35 and 36 of the MiFID Implementing Directive is that, for the purposes of assessing the client's knowledge and experience, certain assumptions can be made by the investment bank in relation to 'professional clients'. In particular, the bank can assume that a professional client 'has the necessary experience and knowledge in order to understand the risks involved in relation to those particular investment services or transactions, or types of transaction or product, for which the client is classified as a professional client'. Certain entities automatically qualify as professional clients

(although it is open to such clients to request a higher level of protection). It is also possible for clients who do not automatically qualify as professional to waive some of the protections otherwise afforded to them although, importantly, s II of Annex II of MiFID provides that such clients cannot be presumed to possess market knowledge and experience comparable to those who automatically qualify. MiFID, therefore, envisages a scheme involving a number of levels of protection depending on what might broadly be described as the 'sophistication' of the client.

Separately from the conduct of business obligations, art 18 of MiFID requires investment firms to take all reasonable steps to identify and manage conflicts of interest between themselves and their clients, or between one client and another. In some cases, conflicts must be disclosed to clients before any business is undertaken.

Pursuant to its rule-making powers under s 138 of the Financial Services and Markets Act 2000 ('FSMA'), the Financial Services Authority implemented MiFID in the UK in the form of rules contained in the Conduct of Business Sourcebook ('COBS'), which came into effect on 1 November 2007. When construing rules made to implement MiFID, the court should first interpret the Directive in accordance with European law and then the relevant rules in accordance with domestic principles in order to achieve conformity with the provisions of MiFID (see *re Lehman Brothers International (Europe) (in administration)* [2010] EWCA Civ 917).

Chapter 10 of COBS implements art 19(5) of MiFID and, subject to certain exceptions, requires the investment bank to assess the client's knowledge and experience, including his familiarity with the kind of investment, the nature, volume and frequency of the client's dealings in such investments and the profession or former profession of the client.

Chapter 3 of COBS deals with the classification of clients into retail clients, professional clients and eligible counterparties. Professional clients are divided into 'per se professional clients' and 'elective professional clients'. The latter category requires various tests to be satisfied, including a 'qualitative test', which involves the investment bank undertaking an adequate assessment of the 'expertise, experience and knowledge of the client that gives reasonable assurance, in the light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved'. Thus, in relation to this category of client, the bank's obligations are tailored to the client's knowledge and experience. Whether the imposition of these obligations might discourage an investment bank from dealing with such a client in the first place is, of course, a different issue.

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## IS A BREACH OF THE RULES ACTIONABLE?

The effect of s 150 of FSMA is that a breach of COBS is 'actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty'. Although this statutory right of action relates to breaches of COBS rather than MiFID, when assessing whether there has been a breach the court will interpret COBS in a manner which conforms with MiFID. A 'private person' is defined by the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001/2256. Broadly speaking, if the loss has been suffered by an entity (as opposed to an individual) in the course of carrying on a business of any kind, it will not qualify as a private person. Section 150(3) of FSMA enables certain contraventions to be prescribed as actionable by anyone (regardless of whether they are a private person), although the contraventions currently so prescribed are unlikely to assist in this context.

There is consequently something of a mismatch between the regulatory protection given to a professional client by COBS and the statutory right of such a client to make a claim in respect of breaches of COBS. In practice, most clients who suffer losses on CDOs are unlikely to qualify as private persons. In such circumstances, a claimant must fall back on the common law.

## 'SOPHISTICATION' AT COMMON LAW

At common law, any particular case is likely to turn on its own facts. The documents passing between the parties will be of critical importance. There may be a contractual relationship which governs the parties' obligations to each other and serves to identify, or limit, the extent of any duties owed to the client. If there is no contractual provision to assist the claimant, then where an investment bank has induced the client to purchase an investment from it by an inaccurate representation, it may be possible to bring a claim under the Misrepresentation Act 1967. This does not require the client to establish that the bank owed it a duty of care. But there are often difficulties with such a claim, for example where the bank is not the party from whom the investor purchased. In such cases a claimant must establish that the bank owed him a duty of care (unless, of course, he can prove dishonesty).

Investors who have claimed against banks have frequently alleged that they were owed a *general* advisory duty of care, but such arguments have often failed on the facts. In the recent case of *JP Morgan Bank (formerly Chase Manhattan Bank) v Springwell Navigation Corp* [2008] EWHC 1186 Gloster J distinguished the recommendations of a salesman from the provision of investment advice. Such recommendations did not give rise to the kind of wide duties alleged, including an obligation to explain the risks of the investment.

It may be possible to establish a more limited duty of care in relation to statements made by the bank. Mance J said in *Bankers Trust International Plc v Dharmala Sakti Sejahtera* [1996] CLC 518 that 'if the bank does give an explanation or tender advice, then it owes a duty to give that explanation or tender that advice fully, accurately and properly. How far that duty goes must once again depend on the precise nature of the circumstances and of the explanation or advice which is tendered'. There is, however, no breach of duty involved in remaining silent: as Lord Hoffmann said in *Commissioners of Customs and Excise v Barclays Bank plc* [2007] 1 AC 181, 'the law of negligence does not impose liability for mere omissions.'

Amongst the key factors affecting whether a duty of care existed are the extent to which the client did, in fact, rely on the investment bank and whether the bank could reasonably have been expected to know that the client was relying on it (see *Caparo Industries plc v Dickman* [1990] 2 AC 605 and *So v HSBC Bank plc* [2009] 1 CLC 503). It is in relation to these factors that the client's 'sophistication' is likely to be relevant, although it should be stressed that the expression 'sophisticated investor' is not a term with a defined legal meaning. If the client knew all about the kind of investment being offered and the risks involved, it will be less likely that he relied on the investment bank when deciding to invest. Similarly, if the bank reasonably believed that the client was experienced and knowledgeable in the relevant respects, it may not be possible to regard it as having assumed any responsibility towards the client such as would give rise to a duty of care.

Factors such as these counted against the claimant in the *Springwell* case: Gloster J held that Springwell was a 'highly sophisticated investor' and that this was a 'pointer against' any duty of care arising; furthermore, the documentation governing the relationship between the parties acknowledged that Springwell was a sophisticated investor and this was decisive. Numerous decisions dealing with complex financial transactions recognise the parties' freedom to contract on a basis which precludes any duty of care arising: see for example, *IFE Fund v Goldman Sachs International* [2007] Lloyds Rep. 449 (CA) and *Titan Steel Wheels Ltd v Royal Bank of Scotland plc* [2010] EWHC 211 (Comm). In *Peekay Intermark Ltd v ANZ Banking Group Ltd* [2006] CLC 582 the Court of Appeal held that a client was bound by the terms of a Risk Disclosure Statement which he had signed, confirming that he understood the nature of the investment and was aware of the risks, even though this was not, in fact, the case.

Thus, whilst categorisation as a 'sophisticated investor' does not *necessarily* preclude a duty of care arising, it is likely to be much more difficult for a client in that category to establish that he was owed a duty.

It is arguable that the relatively new regulatory regime brought in by MiFID and COBS has modified the common law position to some extent. For example, where COBS imposes an obligation to make an assessment of the investor's sophistication, it is arguable that this should influence whether the bank should be taken to know that the client was likely to rely on it. Likewise, it may be argued that the bank ought to appreciate, as a result of art 18 of MiFID, that a client might rely on it to disclose any conflict between that client and, for example, a party who had influenced the choice of reference obligations underlying a CDO. Furthermore, r 2.1.2 of COBS prohibits an investment bank from seeking to exclude or restrict any duty imposed by COBS.

But the impact of the regulations on the existence and scope of a common law duty may not be as great as a claimant would like. For example, the obligation to assess whether the client was sufficiently sophisticated may have been properly carried out, or, if it had been carried out, may anyway have resulted in the client being placed in a category which would have reduced the protection given by the rules. So, for example, although the transactions under consideration in *Springwell* predated the inception of the new regulatory regime, since Gloster J held that Springwell was a 'highly sophisticated investor', it may well have satisfied the qualitative test to be classed as an elective professional client and the obligations which the bank owed to it under COBS would consequently have been fairly limited.

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## CONCLUSION

The common law undoubtedly remains sufficiently flexible to recognise in a suitably clear case that a duty might be owed to a client who, despite being 'sophisticated', had in fact reasonably relied on an investment bank to identify and inform it about unusual risks. But a combination of English law's reluctance to proliferate the duties owed in relation to commercial transactions, together with the (understandable) tendency of banks to include extensive disclaimers within the documentation produced in relation to CDOs and other financial transactions, means that those who invest in such instruments as part of their business are likely to find it difficult to obtain any damages from an investment bank, even if it has been careless. There is a powerful argument that MiFID and COBS, which were implemented after substantial market research, already provide a level of protection to investors which is suited to their level of 'sophistication'. That said, an extension of the statutory right of action under s 150 of FSMA to all investors protected by COBS (regardless of whether they are a private person) might be justified in order to enable those with the benefit of regulatory protection to obtain redress. ■