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Investment risk, loss, and causation

After *Rubenstein v HSBC Bank Plc* [2012] EWCA 1184

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Abstract

In this article John Virgo considers the impact of the recent Court of Appeal decision in *Rubenstein v HSBC Bank Plc* [2012] EWCA Civ 1184 on what constitutes investment advice, the scope of the duties owed by regulated firms to investors under Section 150 of the Financial Services and Markets Act 2000 and the Conduct of Business Rules, and the extent to which non-compliant investment advice can be said to cause financial loss to investors which is recoverable in law.

All investments carry risks. In recommending an investment to a private customer or retail client,[1] the duty of the financial adviser is both to identify those risks and to evaluate them for the client.

The source of the duty lies in the adviser's responsibility to comply with detailed 'Rules' specified by the 'Financial Services Authority' in the 'Conduct of Business Rules' (the 'COB Rules') and the 'Conduct of Business Sourcebook' (the 'COBS Rules').[2] In the case of a private customer the duty was specified by 'COB 5.4.3 R' which provided that:

> a firm must not make a personal recommendation of a transaction for a private customer unless it has taken reasonable steps to ensure that the private customer understands the nature of the risks involved.

In the case of a retail client the duty arises under 'COBS 9.2.2 R' which requires the adviser to:

> obtain from the client such information as is necessary for [him] to understand the essential facts about [the client] and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended . . . (a) meets [the client's] investment objectives; (b) is such that he is able financially to bear any related investment risks consistent with his investment objectives; and (c) is such that he has the necessary experience and knowledge in order to understand the risks involved in the transaction . . . .

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1. For transactions between 1 December 2001 and 30 November 2007, see the customer classification duty in COB 4.1.4 R (before conducting designated investment business with or for any client, a firm must take reasonable steps to establish whether that client is a private customer, intermediate customer, or market counterparty); for transactions from 1 December 2007 see COBS 3.4 R, 3.5, and 3.6 and the revised customer classifications of retail and professional client or eligible counterparty.

2. Both the COB Rules (relevant to transactions between 1 December 2001 and 30 November 2007) and the COBS Rules (relevant to transactions from 1 December 2007) are enforceable by an action for breach of statutory duty under s 150 of the Financial Services and Markets Act 2000 by a 'private person'; In the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 SI 2001/2256 the term 'private person' is defined as:

> (a) any individual, unless [immaterial proviso] . . . [he suffers the loss in question in the course of carrying on — any regulated activity; or any activity which would be a regulated activity apart from any exclusion made by article 72 of the Regulated Activities Order (overseas persons)

and:

> (b) any person who is not an individual, unless he suffers the loss in question in the course of carrying on business of any kind;

It follows this statutory duty is not owed to corporate customers (see *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc* [2010] 2 Lloyd's Rep 92) and is to be noted therefore the definitions of 'private customer', 'retail client', and 'private person' do not wholly overlap.

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In both instances, the function of compliance with the 'COB' and 'COBS Rules' is to ensure that the investment recommended for the customer is a 'suitable' one.[3]

In *Rubenstein v HSBC Bank Plc*,[4] the Court of Appeal had to consider the relationship between the scope of a financial adviser's duty to identify and evaluate the risks posed by a recommended investment and the adviser's legal responsibility for losses experienced by the customer who relied on the recommendation. The case provides important guidance on the parameters of the scope of the duty and on determining the type of loss which will be recognized as having been caused by a breach of that duty. Scope of duty and causation are seen to be intimately linked concepts.[5]

Rubenstein—the facts

The facts of *Rubenstein* may be shortly stated: Mr Rubenstein sought advice from an investment adviser employed by HSBC, Mr Marsden in connection with a suitable product in which to invest the sale proceeds of his matrimonial home while he and his wife looked for a new property. Mr Rubenstein's objectives were to find an investment (if possible) that provided a higher interest rate than a standard bank deposit but importantly he emphasized that he could not afford to take any risk to his capital at all. Mrs Marsden recommended investing the available sum (£1.25m) in an AIG Bond placed in a particular fund—the Enhanced Variable Rate Fund ('the EVRF')—a type of unit linked fund.

The objective of avoiding risk to capital was apparent from a specific enquiry raised by Mr Rubenstein with Mr Marsden. In particular he asked the following question:

> We can't afford to accept any risk in the investment of the principal sum. Can you confirm what – if any – risk is associated with this product?

Mr Marsden responded: 'We view this investment as the same as cash deposited in one of our accounts.'

This was a mis-description of the risk posed by the investment in that the EVRF was not the same as a deposit. The risk the creditor of a deposit would take is primarily with the creditworthiness the deposit taker—a solvency risk.[6] Unless the solvency risk eventuates, the creditor is entitled to the return of his deposit, with interest.

In contrast, an investor in the EVRF was not entitled to the return of his investment, only to its value at the time of request, which could fluctuate on a daily basis. Value there depended on the underlying assets held within the EVRF which could vary between cash and short-dated securities to longer dated securities and complicated derivative products, including 'sub-prime' assets. Unfortunately for Mr Rubenstein, when he requested the return of his investment the EVRF had been suspended following a run on the fund prompted by a well-founded rumour in the US financial markets that AIG was going to go bankrupt (as may have happened if it had not received support from the US Federal Reserve). In due course he was able to withdraw a depleted capital sum and thus experienced at first hand the difference between a 'deposit fund' and a unit linked fund.

The first instance decision

At first instance,[7] the judge found that the bank had been negligent in the advice which it gave, and was in breach of inter alia COB 5.4.3 R. He also found that the investor relied on the bank's advice. Despite these findings, the judge went on to hold that the loss suffered by Mr Rubenstein was not caused by the HSBC's negligence or breach of COB duties: it was caused by unprecedented market turmoil in 2008 which was unforeseeable and too remote. The basis for that view lay in an acceptance of evidence to the effect that the

3. See the 'suitability' requirement in 'COB 5.3.5 R' and in 'COBS 9.2.1 R'.
4. [2012] EWCA 1184.
5. Although concerned with the 'COB Rules' rather than the 'COBS Rules' there is no reason to think the reasoning inapplicable to both regimes.
6. Other risks include a risk of low awards of interest; the risk of any capital and accrued interest being eroded by inflation and a risk of fraud leading to loss of deposits.
7. [2011] EWHC 2304.

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actuarial experts at trial were agreed that although the constitution of the EVRF was very different from a cash deposit nonetheless in September 2005, when the investment was made, the risk inherent in the EVRF was only marginally or slightly higher than that of a conventional deposit. The idea that one of the world's largest insurance companies might go bankrupt was unthinkable in September 2005. The concept of a run on AIG was, the judge accepted, so remote that no financial adviser would have been required to point it out as posing a risk to capital. The judge concluded that what happened to the EVRF on 15 September 2008 and the days following was wholly outside the contemplation of the bank or any competent financial adviser in September 2005.

This led to the finding:

> The damage which eventuated, namely, the closure of the fund and a substantial loss of investors' original capital, was triggered by subsequent events. If those were not events of a kind which were foreseeable when the investment was made, I do not think that it can be said that the structure of the product truly caused the loss . . . the loss was not caused by any negligence on the part of Mr Marsden in making the recommendation . . . the loss was not reasonably foreseeable by HSBC and is too remote in law to be recoverable as damages . . . .[8]

On appeal

In focusing on the market events of 2008 and their immediate linkage to the depletion in the capital value of Mr Rubenstein's investment the Court of Appeal held the judge had confused two separate risks: (i) the risk of default of the institution to which Mr Rubenstein entrusted his money—the 'default risk' and (ii) the risk that arose from market movements—the 'market risk'. Mr Marsden's duty was to identify an investment that was 'suitable' in protecting his money from both risks as far as possible. In fact, there was no 'default' by AIG in paying what was due under the Bond ie the value of the fund on encashment which reflected the underlying value of the assets held in the EVRF. The risk faced by Mr Rubenstein was the risk of market movement—a risk about which Mr Marsden had not adequately warned him and which had been obscured by the misleading description of the investment as being the same as cash deposited in an HSBC deposit account.[9]

In pointing to the unforeseeable market turmoil of 2008 the Court of Appeal accordingly held that judge had identified the wrong cause of Mr Rubenstein's losses. As Rix LJ explained:

> 'Against the background of the facts found and . . . and the scope of HSBC's duties, what connected the erroneous advice and the loss was the combination of putting Mr Rubenstein into a fund which was subject to market losses while at the same time misleading him by telling him that his investment was the same as a cash deposit, when it was not. Therefore, the correct selection of the cause of Mr Rubenstein's loss was the loss in value of the assets in which the EVRF . . . was invested. . . . It was the bank's duty to protect Mr Rubenstein from exposure to market forces when he made clear that he wanted an investment which was without any risk (and when the bank told him that his investment was the same as a cash deposit). It is wrong in such a context to say that when the risk from exposure to market forces arises, the bank is free of responsibility because the incidence of market loss was unexpected.[10]

Thus, scope of duty, causation, and loss came to be logically aligned.

Discussion

The judgment of the Court of Appeal can be seen as throwing interpretive light on a number of pervious

8. ibid, [109, 116].
9. [2012] EWCA 1184 (Rix LJ) [71, 72].
10. ibid, [118].

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cases and as establishing a sound jurisprudential framework for analysis. In particular, it is suggested there will always be three critical questions to answer: (i) What was the scope of the duty undertaken? (ii) Was the loss suffered of a type that was foreseeably likely to arise from a breach of that duty? And (iii) Was the loss in fact caused by the breach of duty?

The application of this three-stage analysis may be exemplified by *Camerata Property Inc v Crédit Suise Securities (Europe) Ltd (No 2)*.[11] In that case, the claimant was advised to invest in a Note issued by a Lehman Brothers subsidiary. The investment was the subject of a total loss due to the issuer's default. The claimant brought two separate actions alleging initially that he ought to have been advised to disinvest once the financial adviser had or ought to have entertained doubts over the solvency of Lehman Brothers—and later that the Note was too risky an investment *ab initio*. In the first action, Andrew Smith J held that there had been no negligence, but that in any event, even if advised to sell, the claimant would have retained the note. The second action was struck out on the basis that the findings at the first trial made the claim impossible. Flaux J commented that the claim would have been bound to fail for the following reason, namely that even if the defendant had been at fault, the 2008 collapse of Lehman Brothers had been unforeseeable in 2007[12]:

> Even if Camerata could establish its general wrong advice case and even if it could show that it would not have invested in the Note had it been given the right advice, the claim for damages would still fail because the actual cause of the loss was issuer default as a consequence of the collapse of Lehman Brothers, which was wholly unexpected and unforeseeable.... In other words, the only reason why Camerata has suffered any loss at all, as opposed to making a substantial profit, is because of the collapse of Lehman Brothers, which was unforeseeable.

The point was that in so far as it was part of the defendant's duty to warn as to the risk of issuer default, no competent adviser would have contemplated there was any serious risk of a Lehman Brothers' collapse and so there was no breach of duty of the given scope. It could thus not be said that the loss suffered was of a type that was foreseeable (loss flowing from any real risk of issuer default). Further, there was no linkage between the loss experienced and any breach of duty.

This may be contrasted with *Brown v KMR Services Ltd*[13] in which the court of appeal considered a claim by a Lloyd's name against his members' agents for exposing him to membership in syndicates which reinsured catastrophe excess of loss without warning him of the high risk nature of his participation. At trial, the judge, Gatehouse J, found that no one had anticipated the size and frequency of the various disasters that occurred between 1987 and 1990. Nevertheless, the claimant recovered for breach of the agents' duty on the basis that if he had been warned he would have limited his exposure. As Hobhouse LJ observed[14]:

> If it was the duty of the defendants to protect the plaintiff from losses of the kind which he subsequently suffers, how can it be just or appropriate to say that, because those losses are larger than either party anticipated, the plaintiff must bear those losses not the defendants?

Again, we see that the Court considered it to be within the scope of the defendant's duty to warn as to the risk of a particular type of loss (liability for excess loss); the loss was foreseeable in kind if not magnitude; but for the breach of duty the claimant would not have made the relevant investment and so

11. [2012] EWHC 7 (Comm), [2012] PNLR 15.
12. ibid, [68, 102].
13. [1995] 2 Lloyd's Rep 513.
14. ibid, [557].

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the breach of duty could be said to have caused the resultant loss.

The analysis may be seen as consistent with the modern approach to assessment of damages laid out in *The Achilleas*.[15] The question was whether a charterer who redelivered the chartered vessel to her owner late, in breach of contract, should be liable for only a conventional rate of damages representing any increase in the market rate for the vessel over and above the charter rate for the period of the overrun, or should be liable for the full extent of the owner's undoubted loss where, due to the late redelivery, the owner had lost a new fixture at the higher market rate. It was held that the owner was limited to the former. Lord Hoffmann stated the relevant principles as follows:

> It is generally accepted that a contracting party will be liable for damages for losses which are unforeseeably large, if loss of that type or kind fell within one or other of the rules in *Hadley v Baxendale*... That is generally an inclusive principle: if losses of that type are foreseeable, damages will include compensation for those losses, however large. But... it may also be an exclusive principle and that a party may not be liable for foreseeable losses because they are not of a type or kind for which he can be treated as having assumed responsibility... What is the basis for deciding whether loss is of the same type or a different type? It is not a question of Platonist metaphysics. The distinction must rest upon some principle of the law of contract. In my opinion, the only rational basis for the distinction is that it reflects what would reasonably have been regarded by the contracting party as significant for the purposes of the risk he was undertaking.[16]

Overall, Rubenstein provides a clear set of principles within which to analyse questions of loss caused to investors by the provision of defective investment advice.

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15. [2009] 1 AC 61.
16. ibid, [21, 22].

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