**Appeal Court reference: 2013/0138**
**Claim No: 2MA40004**

**IN THE COURT OF APPEAL**
**ON APPEAL FROM**

**IN THE HIGH COURT OF JUSTICE**
**QUEEN'S BENCH DIVISION**
**MANCHESTER DISTRICT REGISTRY**
**MERCANTILE COURT**

**BETWEEN:**

**(1) JOHN GREEN**
**(2) PAUL ROWLEY**

**Claimants/Appellants**

**-and-**

**THE ROYAL BANK OF SCOTLAND**

**Defendant/Respondent**

**-and-**

**THE FINANCIAL CONDUCT AUTHORITY**

**Intervener**

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# WRITTEN SUBMISSIONS OF THE FINANCIAL CONDUCT AUTHORITY

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## The Financial Conduct Authority

On 1 April 2013 the Financial Services Authority ("**FSA**") was re-named as the Financial Conduct Authority ("**FCA**") pursuant to section 1A(1) of the Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012). These Written Submissions are filed on behalf of the FCA, as Intervener, pursuant to the Order of Longmore LJ dated 10 May 2013 and are addressed under the following headings:

A. FSA regulation and rule-making powers;
B. Issues in this appeal and the IRHP Review;
C. Interest Rate Hedging Products – regulatory control;
D. IRHPs – types, pricing and valuation;
E. IRHPs – break costs;
F. IRHPs – FSA expectations of disclosure.

**Cross-references:** A slim bundle containing copies of the documents referred to in these Written Submissions is filed herewith for the assistance of the Court and the parties. All references to the copy documents contained in the same take the form "[**FCA/tab/**(where applicable)**page]**".

## **A: FSA regulation and rule-making powers**

1. In December 2001, the FSA became the single regulator of financial services business in the UK under the Financial Services and Markets Act 2000 ("**the Act**"). The FSA was authorised to carry out the regulatory functions conferred on it by the Act.[1] The FSA's regulatory objectives were (a) market confidence, (b) public awareness, (c) the protection of consumers, and (d) the reduction of financial crime, as further elaborated in the Act.[2] Section 5 of the Act explained that the "*protection of consumers*" objective was to secure the appropriate degree of protection for consumers and in considering what degree of protection may be appropriate the FSA was to have regard to the factors listed in s5(2).

2. The Court is no doubt familiar with the FSA's rule making powers contained in Part 10 of the Act; they are identified for ease of reference in a Schedule A to these Submissions.

3. Strengthening consumer protection was an important aim of the Act. The specific aspect of the FCA's work with which these proceedings are concerned is the regulation of the sale of Interest Rate Hedging Products ("**IRHPs**"). The need for the regulation of such products is perhaps obvious although a number of the most salient considerations are set out below:

   (i) Financial products, including those sold to consumers on a retail basis, are frequently complex. The value of the product to the consumer in large part depends upon what is written in the terms and conditions that embody the respective rights and obligations of the product provider and consumer. The nature and value of the product may therefore not be readily apparent to the average consumer, and even less so to the vulnerable consumer.

   (ii) Second (and closely related to the above) there is typically a significant asymmetry in the knowledge and bargaining power of the consumer and the seller of the financial product. Consumers are not, in the main, legally or financially trained, and often seek out financial products, particularly credit, in circumstances of real or perceived need. Regulated firms are, by contrast, frequently well-financed organisations which benefit from sophisticated legal advice.

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[1] Section 1 of the Act (as it was prior to amendment by the Financial Services Act 2012).

[2] Sections 2 – 6 of the Act. The FSA's objectives were amended in certain respects by the Financial Services Act 2010 (the public awareness objective was removed and a new objective of financial stability was introduced). The FCA now has a strategic objective (ensuring that relevant markets work well) and three operational objectives (consumer protection, integrity and competition).

(iii) If financial products are mis-sold, then consumers may suffer financial detriment for a number of reasons. They may outlay money when they would not have done so had the product not been mis-sold. Alternatively, they may lose the opportunity to buy an alternative, more suitable product, and therefore suffer losses flowing from that missed opportunity. More generally, mis-selling may cause inconvenience, anxiety and distress.

(iv) Conversely, firms may generate substantial revenues through non-compliant conduct and, if unchecked, may by so doing gain an unfair advantage over their compliant competitors.

(v) One of the principal aims of regulation in the retail financial markets is to ensure that firms act towards their customers with integrity and treat them fairly, having due regard to their interests. Furthermore, firms should ensure that customers have the necessary information, in a form that they can understand, to decide whether or not to buy the product.

4. In the context of the retail financial markets, the FSA's strategic focus was traditionally upon firms and their treatment of consumers, as opposed to the design of particular products. The FSA's preferred approach, therefore, was to regulate industry practices rather than products themselves.

**B: The issues in this appeal and the IRHP Review**

5. As the Court will be aware, the appeal in this case raises two issues, namely:

(i) Whether the statutory duty of compliance with COB 2.1 and COB 5.4.3 (being regulatory rules in force at the time) gave rise to a duty concurrently owed in tort in the context of a sale in relation to which the bank had not accepted an advisory duty; and

(ii) If so, for the purposes of complying with COB 2.1 and COB 5.4.3, what was required from the bank in relation to the disclosure of break or exit costs.

6. It is only in relation to that second issue that the FCA wishes to make submissions, both in order that the Court may understand how the FCA considers the relevant rules ought to

be construed and applied and in view of the extensive ongoing review it is undertaking into sales of IRHPs made by retail banks to small businesses.[3]

7. The UK's small business community has traditionally borrowed on a variable rate basis, unlike other markets such as USA and mainland Europe. The FCA understands that the sale of IRHPs by banks to small businesses is a relatively new phenomenon, beginning in the late 1990s and peaking in 2006-2008. Due to concerns about these sales, in 2012, the FCA carried out an initial review of such sales by a number of retail banks to small businesses. It published its findings in June 2012 [**FCA/11**]. It found serious failings in sales of IRHPs by a number of banks and one of the specific concerns raised was poor disclosure of potential break costs. This poor disclosure was exacerbated by the fact that UK small businesses' understanding of 'break costs', in relation to such relatively new products, was rooted in certain UK cultural factors. For example, it was clear that many of these consumers associated 'break costs' with early repayment charges on residential mortgages, typically capped at a number of month's interest or a small percentage of the notional amount.

8. As a result of that review, the FCA entered into agreements with a number of retail banks, including the Respondent, pursuant to which those banks agreed to carry out a proactive redress and past business review exercise in relation to sales of IRHPs (including swaps) made to certain eligible customers on or after 1 December 2001 ("**the IRHP Review**"). As part of the IRHP Review, each bank agreed to appoint an 'independent reviewer', approved by the FCA, to ensure that the review was carried out objectively and consistently, and that fair and reasonable redress was paid to the customer where appropriate. A significant aspect of the IRHP Review involves the bank and the independent reviewer assessing whether, in selling an IRHP to a customer, the bank complied with the relevant regulatory requirements in force at the time of the sale.

9. The second issue in this appeal (whether obiter or otherwise) is therefore potentially of considerable relevance to the customers whose transactions are being, or will be, assessed as part of the IRHP Review. As that Review involves a number of retail banks and around 40,000 transactions, there are a large number of potentially affected customers.

[3] FCA's letter to the Court, dated 17 April 2013, in support of the application for intervention. [**FCA/15**]

**C: Interest Rate Hedging Products – regulatory control**

10. The swap transaction in the present Appeal (**"the Swap"**) was entered into in May 2005. The Conduct of Business Rules ("**COB**") in force at the material time applied to firms with respect to the carrying on of "*all regulated activities*" (subject to certain specified immaterial exceptions) and to "*unregulated activities to the extent specified in any provision of COB*"; see COB 1.3.1R. As the Swap was a 'contract for differences' within the meaning of Article 85 of the *Regulated Activities Order 2001* (SI 2001/544)[4], entering into it constituted such a regulated activity; see s22 of the Act and Articles 4, 14, 73 and 85 of the Regulated Activities Order 2001. (For present purposes and having regard to s22 of the Act, Articles 4, 14, 73 and 85 of the Regulated Activities Order and the COB Glossary:
    (i) the Respondent Bank was a '*firm*',
    (ii) the Appellants were (as categorised by the Bank) 'a *private customer*'[5],
    (iii) the Swap, being a '*contract for differences*', was a '*derivative*'; and
    (iv) the sale of the Swap by the Bank constituted '*designated investment business*'.)

11. The relevant COB Rules and Guidance were the following:
    (i) **COB 2.1.1R**: "(1) This section [COB 2.1 Clear, fair and not misleading communication] applies to a *firm* when it communicates information to a *customer* in the course of, or in connection with, its *designated investment business*."
    (ii) **COB 2.1.2G**: "The purpose of this section is to restate, in slightly amended form, and as a separate *rule*, the part of *Principle 7* (Communications with clients) that relates to communication of information. This enables a *customer*, who is a *private person*, to bring an action for damages under section 150 of the *Act* to recover loss resulting from a *firm* communicating information, in the course of *designated investment business*, in a way that is not clear or fair, or is misleading."
    (iii) **COB 2.1.3R**: "When a *firm* communicates information to a *customer*, the *firm,* must take reasonable steps to communicate in a way which is clear, fair and not misleading."

[4] Being a "*contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in … an index or other factor designated for that purpose in the contract*"; see Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council (Islington London Borough Council, third party) [1995] 1 All ER 1 @ 12-13

[5] In contradistinction to 'intermediate customers' and 'market counterparties'; i.e. private customers were the least relevantly skilled and experienced customers and therefore warranted the greatest regulatory protections.

(iv) **COB 2.1.4G**: "When considering the requirements of *COB 2.1.3R,* a *firm* should have regard to the *customer's* knowledge of the *designated investment business* to which the information relates."

(v) **COB 2.1.5G**: "*COB 2.1* embraces all communications with *customers*, for example:."

(vi) **COB 5.4.1R**: "This section [Customers' understanding of risk] applies to a *firm* that conducts *designated investment business* with or for a *private customer* but does not apply to a *firm* when *providing basic advice on a stakeholder product*."

(vii) **COB 5.4.2G**: "*Principle* 7 (Communications with clients) requires a *firm* to pay due regard to the information needs of its *clients* and communicate information to them in a way that is clear, fair and not misleading. *Principle* 9 (Customers: relationships of trust) requires a *firm* to take reasonable care to ensure the suitability of its advice and discretionary decisions. The purpose of this section is to ensure that a *firm* takes reasonable steps to ensure that a *private customer* understands the nature of the risks inherent in certain transactions."

(viii) **COB 5.4.3R**: "A *firm* must not:

(1) make a *personal recommendation* of a transaction; or

(2) act as a discretionary *investment manager*; or

(3) *arrange (bring about)* or execute a *deal* in a *warrant* or *derivative*; or

(4) engage in *stock lending activity*;

with, to or for a *private customer* unless it has taken reasonable steps to ensure that the *private customer* understands the nature of the risks involved."

12. In interpreting the **COB** provisions, regard must also be had to both the General Provisions Sourcebook (**GEN**) and (as highlighted by the text of the COB) to the overarching Principles for Businesses (**PRIN**) contained in the then FSA Handbook. In particular, the FCA refers to the following material provisions:

(i) **GEN 2.2.1R**: "Every provision in the *Handbook* must be interpreted in the light of its purpose."

(ii) **GEN 2.2.2G**: "The purpose of any provision in the *Handbook* is to be gathered first and foremost from the text of the provision in question and its context among other relevant provisions. The *guidance* given on the purpose of a provision is intended as an explanation to assist readers of the *Handbook*. As such, *guidance*

may assist the reader in assessing the purpose of the provision, but it should not be taken as a complete or definitive explanation of a provision's purpose."

(iii) **PRIN 1.1.2G**: "The *Principles* are a general statement of the fundamental obligations of *firms* under the *regulatory system*. They derive their authority from the *FSA's* rule-making powers as set out in the *Act* and reflect the *regulatory objectives*."

(iv) **PRIN 1.1.9G**: "Some of the other *rules* and *guidance* in the *Handbook* deal with the bearing of the *Principles* upon particular circumstances. However, since the *Principles* are also designed as a general statement of regulatory requirements applicable in new or unforeseen situations, and in situations in which there is no need for *guidance*, the *FSA's* other *rules* and *guidance* should not be viewed as exhausting the implications of the *Principles* themselves."

(v) **PRIN 1.2.1G**: "*Principles* 6 (Customers' interests), 7 (Communications with clients), 8 (Conflicts of interest), 9 (Customers: relationships of trust) and 10 (Clients' assets) impose requirements on *firms* expressly in relation to their *clients* or *customers*. These requirements depend, in part, on the characteristics of the *client* or *customer* concerned. This is because what is "due regard" (in *Principles* 6 and 7), "fairly" (in *Principles* 6 and 8), "clear, fair and not misleading" (in *Principle* 7), "reasonable care" (in *Principle* 9) or "adequate" (in *Principle* 10) will, of course, depend on those characteristics. For example, the information needs of a general insurance broker will be different from those of a retail general insurance *policyholder*."

(vi) **PRIN 1.2.3G**: "All *firms*, except those intending only to *provide basic advice on a stakeholder product*, are required by COB 4.1.4R (Requirement to classify) to classify a *client* before conducting *designated investment business* with or for him, and that classification will be applicable for the purposes of *Principles* 6, 7, 8 and 9."

(vii) **PRIN 2.1.1R**: "The *Principles*.." (A table of the relevant principles appears in Schedule B.) The key Principle 7, "Communications with clients", provides "A *firm* must pay due regard to the information needs of its *clients*, and communicate information to them in a way which is clear, fair and not misleading".

13. As is encapsulated in PRIN 1.1.2G, the Principles were (and still are) the cornerstone of the FSA's Handbook. They applied across the spectrum of regulated persons and activities and were succinct high-level statements of firms' fundamental obligations. They were intended to endure and be capable of relevant application to the infinite variety of circumstances that may arise in the course of a regulated firm's activities.

14. The Principles must be interpreted in the light of their purpose, a principal one of which was the protection of customers' interests. A related purpose was also to bring within the scope of regulation all conduct that posed a threat to the regulatory objectives irrespective of whether or not it fell within a more detailed rule. Given the complexity of financial markets and products, the differing attributes of the customers with whom regulated firms deal and the variety and unpredictability of the circumstances in which regulated conduct occurs, it would not have been feasible for the FSA to make detailed rules for all circumstances, especially so far as fairness is concerned.[6] As Ouseley J held in R (on the application of BBA) v FSA [2011] EWHC 999 (Admin) @ [166]:

> *"...The Principles "occupy the field"; they stand over the specific rules. It is the general performing its role as the overarching requirement which cannot be displaced by compliance with specific rules if the overarching requirement is breached. Since the correct starting point is that the Principles govern the sales activities of the firms at all times, the real question is whether there is any reason to interpret a specific rule as excluding the general so that a breach of the Principles goes unredressed, even though a specific rule has been complied with."*

**D: IRHP – types, pricing and valuation:**

*Types:*

15. It is anticipated that the Court will be familiar with the general types of financial derivatives used as IRHPs, namely (i) interest rate swaps, (ii) interest rate caps (iii) simple interest rate collars, and (iv) structured interest rate collars. However, for the Court's ease of reference, brief general descriptions of such products are set out in Schedule C.

[6] The FSA made numerous public statements to this effect, see for example in a paper issued in July 2004, entitled '*Treating customers fairly – progress and next steps*' (@2.8):
*"Detailed rules are suitable for many areas of regulation, but in the field of fairness, which is flexible and dynamic, varying with particular circumstances, their impact can be limited. They tend to set a single standard and do not provide the flexibility that firms need to deliver fair treatment in a way that fits their target group of customers and their individual strategy. Principles do offer this flexibility."* **[FCA/9/10]**

*Pricing and valuation:*

16. Calculating the price or 'strike rate' of each such IRHP is a complex process for those unfamiliar with derivatives. However, banks can derive a 'yield curve' from the market (such as for LIBOR swaps), which shows the price of swaps in a given market over different periods of time – in short, it is a proxy for the wholesale market's expectations of interest rates over a given time horizon.

17. Thus, if current interest rates are 5% and the average market expectation is that interest rates will remain stable over the next 10 years, the yield curve would show the wholesale price of a 10 year swap to be 5%. The bank would consequently be able to enter into such contracts with wholesale counterparties. If the average market expectation is that interest rates will rise above the current 5%, the relevant price for a 10-year swap would be the expected average interest rate over the period (i.e. above 5%).

18. The banks effectively make/made a profit selling these products to private customers by charging a 'margin' on the price available to them in the wholesale market. For example, if the par swap rate for a 10-year LIBOR swap in the wholesale market is 5%, the bank may charge the customer 5.5%. The margin in this instance is the difference between 5% and 5.5% or, alternatively expressed, the difference between the market's expectations of rates over a 10 year horizon and the amount the customer is liable to pay. As a result, if, as expected, rates did not move over 10 years, the customer would make payments of 0.5% for each of the 10 years of the swap – 5% of the notional value of the derivative contract. This 5% of the notional amount would be the bank's profit on the sale of the product (ignoring the time-value of money).

19. A similar principle is used in the sale of collars and caps. For standalone caps, the banks will simply charge the customer an additional margin compared to the wholesale rate; and for collars, the margin is the difference between the cap bought by the customer and the floor bought by the bank and each component's wholesale price.

20. As with all derivative contracts, IRHPs have an ongoing intrinsic value. Under fair value accounting, banks "mark-to-market" their assets and liabilities on an ongoing basis and accordingly will regularly re-assess the value of the IRHPs in their books. When the net present value ("**NPV**") of the IRHP is positive, this demonstrates that market expectations

are that the payments due under the contract will be in the Bank's (net) favour over the remainder of its term; the Bank is therefore 'in-the-money' and the IRHP is marked as an asset, with such value, on its balance sheet. By contrast, where the NPV is negative, this demonstrates that the market expectations are that the future payments due under the contract will be against the Bank overall; it is therefore 'out-of-the-money' and the NPV of the IRHP is marked as a corresponding liability on its books.

21. Calculation of the NPV takes into account a number of issues, the most important being:
    (i) The difference between the expected cash inflows (i.e. payments from the customer to the bank) and the expected cash outflows (i.e. payments from the bank to the customer). (These are derived from the yield curve, a proxy for the market's expectations of future interest rates, referred to in paragraph 16 above.)
    (ii) The time-value of money, which represents the fact that a pound received today is worth more than the commitment to pay a pound in the future. (To calculate the NPV, all future cash flows must be discounted using an appropriate discount factor.)

22. Assuming there is no counter-party credit risk, the net of a derivative contract will always equal zero; when one counterparty is 'in-the-money' by a given amount, the other counterparty will necessarily be 'out-of-the-money' by the same amount. However, unlike the banks, many private customers (and many of the small businesses in the scope of the IRHP Review), do not participate in fair value accounting and therefore do not regularly (if ever) 'mark-to-market' the value of their financial instruments in this way.

**E: IRHP – break costs**

23. The exit or break costs of any derivative, being the price of its termination, can of course be individually stipulated in the transaction and must be assessed in accordance with such terms. However, usually, and/or by default, such costs will amount to payment of the NPV of the transaction to the counterparty which is 'in-the-money'.

24. As already identified, the bank will be 'in-the-money' (and the customer required to make payment), where the firm expects (overall) to receive future payments until the contract ends (presuming that yield curve expectations are accurate). When the derivative contract is terminated, the bank has to write down the value of the asset on its books to £0; and without a corresponding payment from the customer the write-down of the asset

to £0 would have a negative impact on that year's profit and loss account and overall balance sheet. In short, the 'break costs' are the NPV (being the value of the asset the Bank has lost upon its termination by the customer). However, unless the customer appreciates that the contract has such an inherent value to the Bank, it will not understand the risk of such economic costs crystallising[7].

25. Of course, the potential break costs increase the further interest rates (and/or the market expectations of future interest rates) fall.

26. The only situation in which such an IRHP will not have a break cost for the customer is when both interest rates and future expectations of interest rates rise sufficiently far above market expectations to counteract the impact of the margin charged by the bank. For example, in a 10 year 5.5% swap where, at the time of sale market expectations were that the rate would remain stable at 5%, market expectations of interest rates would have to change to be, on average, greater than 5.5% over the term of the swap.

**F: IRHP – FSA expectations of disclosure**

27. On the facts the Judge found that even if COB 2.1.3R and COB 5.4.3R had been relevant to the duty not to mis-state, he would have found no breach of COB 2.1.3R, finding the explanation given to be neither unfair, misleading nor unclear; in relation to COB 5.4.3R the Judge found that the explanation given in the Brochure *"satisfied the requirement that reasonable steps be taken to explain the nature of the risks involved in the Swap"*.[8] The FCA is concerned by this analysis; the Judge appears to have decided what was required by COB 2.1.3R and COB 5.4.3R but how he arrives at this conclusion is somewhat opaque. Moreover, the FCA's position is that the relevant regulatory requirements extend far beyond the substance of the common law duty not to make misrepresentations.

28. The starting point for any analysis of what was required under COB 5.4.3R is the substance of Principle 7 and COB 2.1.3R, namely that when communicating information

[7] Assuming falling interest rates, the customer already has an 'economic liability' which, under the ordinary performance of the contract, it would discharge gradually by payments to the Bank over time. However, as already noted, there was a cultural rooting within the UK small business community that 'exit costs' would be similar to 'early redemption' fees payable in respect of domestic mortgages, which were typically capped at a number of months' interest or a relatively small percentage of the notional amount; the magnitude of IRHP exit costs therefore appears to have come as a surprise to many.

[8] @ paragraph [85].

to customers, firms, must take reasonable steps to communicate with them in a way which is clear, fair and not misleading. As set out in Section C, COB 5.4 contained rules relating to customers' understanding of risk which applied where a firm conducted designated investment business with or for a private customer. As identified in COB 5.4.2G, the purpose of COB 5.4 (as with COB 2.1.3R and Principle 7) was to ensure that firms took reasonable steps to ensure that their private customers understood the nature of the risks inherent in certain transactions. This would necessarily involve an assessment of the individual customer's information needs.

29. As set out above, the main substantive rule, COB 5.4.3R, relevantly provided that:

> "A *firm* must not:
> (1) make a *personal recommendation* of a transaction; or
> …
> (3) *arrange (bring about)* or execute a deal in a *warrant* or *derivative*
> …
> with, to or for a *private customer* unless it has taken reasonable steps to ensure that the *private customer* understands the nature of the risks involved."

30. The (second) issue in the Appeal is therefore whether the Bank *took* reasonable steps to ensure that the Appellants understood the nature of the risks involved in the Swap for the purposes of COB 5.4.3R and in line with Principle 7. Firms should not have considered the requirements of COB 5.4.3R in isolation; as with any customer, in considering what constituted such reasonable steps, regard had to be had to the Appellants' information needs, and any relevant information had to be communicated to them in a way which was clear, fair and not misleading (for the purposes of COB 2.1.3 and Principle 7). (In this regard, it is notable that COB 5.4.3R applied equally both to advised and arrangement or execution only transactions, as did COB 2.1.3R and the Principles).

31. At the material time, **COB 5.4.4E** provided that "The reasonable steps in COB 5.4.3 R should include the steps set out in COB 5.4.6 E to COB 5.4.12 E as appropriate, in relation to transactions in the following types of *investment* or activity: (1) *warrants* and *derivatives* (see COB 5.4.6 E, COB 5.4.6A E or COB 5.4.6C E as appropriate); ...". Furthermore, **COB 5.4.5E** provided that "Contravention of COB 5.4.4 E may be relied on as tending to establish contravention of COB 5.4.3 R".[9]

[9] As stated in the *Reader's Guide to the Handbook* (@p24):

32. For the purposes of a simple interest rate swap, the relevant steps were those set out in COB 5.4.6E namely (in so far as material):

> "(1) In relation to a transaction in a *warrant* or *derivative* (other than a *retail securitised derivative* or an *option* or *contract for differences* to which COB 5.4.6C E applies[10]), the *firm* should:
> (a) provide the *private customer* with the notice in COB 5 Annex 1 E (Warrants and derivatives risk warning notice); and
> (b) require the *private customer* to acknowledge receipt of the notice and confirm acceptance of its contents, in writing."

A copy of the then applicable 'warrants and derivatives risk warning notice' in COB 5 Annex 1 E is at [**FCA/6].**

33. Although, on 1 September 2005 (after the Swap), COB 5.4.5E was amended to read: "Compliance with COB 5.4.4E may be relied on as tending to establish compliance with COB 5.4.3R."; the purpose of this change was explained by the FCA as being a response to concerns raised about whether the provision of a bespoke, more focused, notice would, although it might be desirable for the consumer, tend to establish a contravention.[11]

34. Accordingly, it was (and remained, notwithstanding the amended wording) the FCA's position that mere compliance with COB 5.4.4E would not necessarily suffice for the purposes of satisfying COB 5.4.3R; as was made clear in COB 5.4.4E "The reasonable

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*"Such evidential provisions are thus indicative in nature: they create rebuttable presumptions of compliance with or contravention of the binding rules to which they refer."*

[10] COB 5.4.6C E applied to "..an *option* or *contract for differences* which is included on the *official list* of an *EEA State* other than the *United Kingdom* .." and is therefore not relevant for present purposes.

[11] *Financial Services Authority, Quarterly Consultation (No. 4) 05/6*, dated April 2005. [**FCA/10/11-12**] The relevant extract from the Consultation Paper reads:

> *""4.5 We have recently received a number of enquiries from firms and a trade association seeking to provide private customers with a bespoke risk warning notice which reflects the nature and risks of particular products in a more focused manner than permitted by the standard risk warning notice in Annex 1E to COB 5. As currently worded, COB 5.4.5E makes this more difficult for firms to undertake, as the evidential provision tends to establish a contravention of the rule, rather than compliance. So a firm that does not issue a private customer with the risk warning notice in Annex 1E to COB 5 would have a further hurdle to establish compliance with COB 5.4.3R.*
>
> *4.6 We intend to change the wording of the evidential provision so that complying with COB 5.4.4E will tend to establish compliance with COB 5.4.3R. The new wording will allow firms to comply with the rule by using the risk warning notice we provide, but also allow them to comply by using a bespoke risk warning notice.*
>
> *4.7 Firms are reminded that where they issue bespoke risk warnings to retail clients, it is essential that those risk warnings are designed to comply with the purpose of COB 5.4 – Customers' Understanding of Risk – as stated in COB 5.4.2G and, specifically, COB 5.4.3R.".""*

The evidential provision no longer appeared in the Handbook after 1 November 2007.

steps in COB 5.4.3 R should include the steps set out in COB 5.4.6 E to COB 5.4.12 E...." [emphasis added]. Having assessed the information needs of the customer, including its understanding of derivative products (both generally and specifically) and any relevant requests for information, it *might* be the case that service of the COB 5 Annex 1 E notice would suffice but equally it might be the case that further steps were required in order to comply with COB 5.4.3 R in the context of the individual case. Accordingly, insofar as any rebuttable presumption of compliance was created by the subsequently amended terms of COB 5.4.5E, it was a presumption which, given (a) the requirements of COB 5.4.3R and the relevance of COB 2.1.3R and Principle 7 and (b) the complexities of the products in question, would ordinarily be rebutted.

35. In this regard the FCA takes issue with the Bank's assertion, in paragraph 21 of its Skeleton Argument, that the duty under COB 5.4.3R was "*usually discharged by way of the provision by the firm of a "risk warning" in prescribed form ... and by the firm requiring that the customer sign its acceptance of the terms of the warning*". In fact, the firm was required to assess each individual customer's needs for the purposes of determining whether provision of the COB 5 Annex 1 E notice was suitably clear, fair and not misleading as well as sufficient and what, if any, additional information should be provided to that individual customer for the purposes of enabling it to understand the nature of the risks involved.

36. The FCA also takes issue with the assertion, at paragraphs 43-47 of the Bank's Skeleton Argument, that COB 5.4.3 was concerned only "*with the identification of qualitative risks of a transaction, not the provision of quantitative information about certain risks",* if, by that submission, the Bank means, that COB 5.4.3 would never require a firm to provide indicative numerical information, where the reasonable provision of that information would enable the customer to understand the true nature of the relevant risk/s involved.

37. Further, whilst the Bank rightly accepts that disclosure (leaving aside its quality) of breakage costs is a matter falling within the duties under COB 5.4.3, it contends that such costs are only an 'ancillary matter' (using the language of the Judge in paragraph 85) and 'do not arise from ordinary performance of the contract'. By contrast, the FCA's position (as was its position at the time) is that the "reversibility" or otherwise of an IRHP *is* an inherent feature of the transaction and, accordingly, to the extent that there are associated,

and potentially very substantial, costs involved in the exercise of such exit or break terms, these should be disclosed to the customer in a way which is clear, fair and not misleading, and which would enable the individual customer to understand the nature of the risks involved. Moreover, whilst the *generic* nature of the risk is a financial one, the true nature of the relevant risk cannot be 'understood' without having regard to its potential magnitude (irrespective of its likelihood); the risk of having to pay up to £50 is of a very different nature to the risk (however theoretical) of having to pay up to £500,000.

38. By way of example, communicating to a customer the fact that it can 'exit' from, say, a 10-year 5.5% simple interest rate swap (where the bank takes a margin of 0.5%), at a cost of 'the then market value of the transaction to the Bank', will not enable an unsophisticated customer with no experience of derivative products to understand that such cost could, 2 years into the swap and in the event of market expectations of interest rates dropping to 4% and being expected to remain at such level for the remaining duration, amount to as much as 12% of the notional value of the swap (being the 1% rate differential plus 0.5% margin payable per annum for the remaining 8 years of the swap, ignoring the time-value of money)[12]; it was therefore not, as stated by the Judge[13], merely a "*theoretical risk*". Furthermore, the customer may be unlikely to appreciate the effect of the Bank's margin upon likely/possible exit costs; i.e. even if the transaction was terminated immediately, there could still be a significant cost[14]. There may therefore be cases in which, based upon the information needs of the customer, only an illustrative example/s will suffice. Equally, there may be cases in which only a broad explanation of the calculation of the likely costs will in fact suffice.

39. It is therefore clear that Banks knew or should have known about the risk of the break or exit costs being substantial. It is also clear that such illustrative calculations could reasonably be prepared and provided as is demonstrated by example disclosures of break costs given by other banks: in case they should be of assistance to the Court, copies of

[12] In this example, if market expectations of future interest rates dropped to 3%, the exit costs could be as much as 20%, and if market expectations of future interest rates dropped to 2%, the exit costs could be as much as 28%.

[13] @ paragraph [87].

[14] See paragraph [18] above. If the Bank's margin was say 0.5%, immediately terminating a 10-year 5.5% simple interest rate swap (i.e. assuming the market's expectation is that there will be no movement in future interest rates, such that they will remain static at 5%) could still result in the customer being liable for 5% of the notional value of the swap (being the bank's expected 0.5% margin for each of the 10 years of the remaining term, ignoring the time-value of money).

some such examples are produced at [**FCA/14**]**.** (As a further illustration of what the FCA considers could reasonably be expected to be disclosed by banks in relation to breakage or exit costs, the FCA additionally refers to the specific regulatory requirements relating to mortgage contracts, which, by their nature, were far less complicated products for the consumer to understand; [**FCA/13**].) Provision of such illustrative examples would generally serve to meet what the FCA would regard as the key requirements for reasonable steps taken to ensure that the customer understands both (i) the mechanics of how any break costs would fall to be calculated under the swap and (ii) the potential quantum of such costs. COB 5.4.3R required Banks to consider these issues, recognising that it is inherent in the nature of the relevant rules and guidance that each case will necessarily involve a unique fact-based assessment of the individual customer's information needs, the product in question and the customer's experience (if any) of that product or any like product.

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**Schedule A:**

**<u>The FSA's power to make rules and to give guidance</u>**

Part 10 of the Act gave the FSA various powers to make rules and to give guidance. In making rules and in giving guidance, the FSA had to, so far as reasonably possible, act in a way that (a) was compatible with the regulatory objectives identified in sections 2 to 6 of the Act (see paragraph 2 above), and (b) the FSA considered most appropriate for the purpose of meeting those objectives.

*(a) Rules*

The FSA had a general power to make such rules applying to authorised persons with respect to the carrying on by them of regulated activities and unregulated activities as appeared to be necessary or expedient for the purpose of meeting its regulatory objectives.[15]

The FSA could also make rules that took effect as "evidential provisions", whose contravention would tend to establish evidence as to whether or not a rule had been complied with.[16] The Act provided that contravention of such a rule did not give rise to any of the consequences provided for by other provisions of the Act.

*(b) Guidance*

The FSA could additionally give guidance consisting of such information and advice as it considered appropriate (a) with respect to the operation of the Act and of any rules made under it, (b) with respect to any matters relating to the functions of the FSA, (c) for the purpose of meeting the regulatory objectives, and (d) with respect to any other matters about which it appeared to the FSA to be desirable to give information or advice.[17]

Guidance did not, and under the amended Act does not, affect firms' regulatory obligations. The FSA issued guidance where it considered that this would help firms to decide what action they may wish to take to comply with their existing regulatory obligations.

The FSA explained the role of guidance in paragraphs 2.22-2.27 of the Enforcement Guide [**FCA/8**]. The key points were these:

(i) Guidance is not binding.

(ii) Guidance is intended to illustrate ways (but not the only ways) in which a person can comply with relevant rules.

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[15] This was in section 138(1) of the Act, which was amended by the Financial Services Act 2010 with effect from 8 April 2010. Prior to then, the relevant purpose for making general rules was to protect the interests of consumers but nothing turns on the amendment. Pursuant to the Financial Services Act 2012, the FCA's general-rule making power is now in section 137A.

[16] Section 149 of the Act. This substance of this provision is now in section 138C.

[17] Section 157 of the Act. The substance of this provision is now in section 139A.

(iii) There is no presumption that departing from Guidance indicates a breach of a Rule. If a firm has complied with the Principles and other Rules, then it does not matter whether or not it has also complied with any Guidance.

(iv) The FSA would not take action against a firm that has acted in accordance with Guidance.

(v) Where a firm has breached a Principle or other Rule (which is to be assessed without regard to any Guidance), Guidance may be relevant to consideration of whether or not the firm should have known that it was acting in breach and of the seriousness of the breach.

In exercising its rule making powers for the protection of consumers, in considering the degree of protection appropriate the FSA was to have regard to[18]:

a. the differing degrees of risk involved in different kinds of investment or other transaction;
b. the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity;
c. the needs that consumers may have for advice and accurate information; and
d. the general principle that consumers should take responsibility for their decisions.

[18] Section 5 of the Act.

**Schedule B:**

**PRIN 2.1.1R: “The *Principles*..”**

| **1 Integrity** | A *firm* must conduct its business with integrity. |
|---|---|
| **...** | |
| **6 Customers' interests** | A *firm* must pay due regard to the interests of its *customers* and treat them fairly. |
| **7 Communications with clients** | |
| **8 Conflicts of interest** | A *firm* must manage conflicts of interest fairly, both between itself and its customers and between a *customer* and another *client*. |
| **9 Customers: relationships of trust** | A *firm* must take reasonable care to ensure the suitability of its advice and discretionary decisions for any *customer* who is entitled to rely upon its judgment. |
| **...** | |

**Schedule C:**

**General descriptions of the following IRHPs: (i) interest rate swaps, (ii) interest rate caps, (iii) “simple” interest rate collars and (iv) “structured” interest rate collars.**

Interest rate swap

1. An interest rate swap is an agreement between two parties whereby one type of interest payment is swapped for another, such as exchanging a fixed interest rate payment for a floating payment, based on a notional amount.

2. For example, a small business may enter an interest rate swap contract with its bank to ‘swap’ a floating rate payment for a fixed interest rate payment on a notional value of £1.5 million. Thus, the small business may pay the bank a fixed amount (e.g. 5% or £75,000) and receive from the bank a floating rate (e.g. LIBOR). In practice, this means that if the floating interest rate payment increases because LIBOR rises, the small business receives an amount above that due under the fixed payment. Conversely, if the floating interest rate payment decreases as a result of LIBOR falling, the small business continues to pay the fixed amount, but receives less in return.

3. If there is a separate variable rate loan agreement between the bank and the small business that matches the £1.5 million notional value of the swap the product can thus be used to ‘fix’ the interest payments on the loan, netting off the payment due under the variable rate loan and the cashflows due under the swap, remains the same at each repayment date.

Interest rate cap

4. An interest rate cap is an agreement under the buyer receives payments at the end of each period in which the interest rate exceeds the agreed strike rate. In almost all circumstances the small business is the buyer of the cap. The price of the cap might be paid by an upfront fee, by increasing the value of the underlying loan (if there is an underlying loan) or by spreading out the cost of the cap over the lifetime of the cap. The lower the agreed strike rate, the higher the fee payable by the small business.

5. For example, under a cap agreement, the bank and the small business would only agree to exchange payments when the interest rate exceeds the agreed strike rate (e.g. 6.5%). Thus, the small business makes or receives no payment under the cap contract when the interest rate is below 6.5%, but when the interest rate exceeds 6.5% the small business receives the difference between the actual interest rate and the strike rate as a payment.

6. If there is a separate variable rate loan agreement between the bank and the small business that matches the notional value of the cap the product can thus be used to 'cap'the interest payments on the loan at the agreed strike rate.

"Simple" interest rate collar

7. A simple interest rate collar is sold by banks to small businesses as a means of 'limiting' interest rates within certain pre-agreed levels. A simple interest rate collar involves two derivative contracts – a cap and a floor. The cap has been considered above.

8. Under the floor, the buyer receives payments at the end of each period in which the interest rate is below the agreed strike rate. In almost all circumstances the small business is the seller of the floor. The bank and the small business would only agree to exchange payments when the interest rate falls below the agreed strike rate (e.g. 4%). Thus, the small business makes or receives no payment under the floor contract when the interest rate is above 4%, but when the interest rate falls below 4% the bank receives the difference between the actual interest rate and the strike rate as a payment from the small business.

9. If there is a separate variable rate loan agreement between the bank and the small business that matches the notional value of the cap and floor the product can thus be used to 'limit' the interest payments on the loan within the levels stipulated by the strike rates of the cap and floor.

10. The small business can 'purchase' the cap from the bank; the lower the agreed strike rate, the higher the fee. Equally, the bank can 'purchase' the floor from the small business; the higher the agreed strike rate, the higher the fee. In many cases, these collars were marketed to small businesses as 'no upfront cost' – i.e. the bank and the small business agreed not to exchange upfront payments, presumably because the value of the floor sold by the small business was seen to be equal to the value of the cap sold by the bank.

"Structured" interest rate collar[19]

11. Structured interest rate collars are in many respects similar to simple collars and are also sold by banks to small businesses as a means of 'limiting' interest rates within certain pre-agreed levels.

[19] As part of the IRHP review, the banks have agreed that structured collars were too complex to be sold to non-sophisticated small business customers given the inherent speculation that such products involved and, therefore, any business sold such a product will be automatically eligible for fair and reasonable redress under the Review.

12. Structured interest rate collars also contain a cap and a floor element that work in the same way as with a simple collar. However, there is an additional floor agreement between the bank and the small business, which can work in slightly different ways but effectively means that if interest rates fall below the agreed strike rate the bank receives the difference between the actual interest rate and a rate above the strike rate as a payment from the small business.

13. For example, as with a simple collar the small business and the bank may agree a cap of 6.5% and a floor of 4%. However, the additional floor may have an agreed strike rate of 3.5% below which the small business agrees to pay the difference between the interest rate and the cap rate of 6.5%.

14. Thus, whilst interest rates are between 4% and 6.5% the small business and the bank exchange no payments. When the interest rate exceeds 6.5% the small business receives the difference between the actual interest rate and the strike rate (6.5%) as a payment. When the interest rate falls below 4%, but not below 3.5%, the bank receives the difference between the actual interest rate and the strike rate (3.5%) as a payment from the small business. When the interest rate falls below 3.5%, the bank receives the difference between the actual interest rate and the strike rate of the cap (6.5%) as a payment from the small business.

**Appeal Court reference: 2013/0138**

**Claim No: 2MA40004**

**IN THE COURT OF APPEAL**
**ON APPEAL FROM**

**IN THE HIGH COURT OF JUSTICE**
**QUEEN'S BENCH DIVISION**
**MANCHESTER DISTRICT REGISTRY**
**MERCANTILE COURT**

**BETWEEN:**

**(1) JOHN GREEN**
**(2) PAUL ROWLEY**

**Claimants/Appellants**

**-and-**

**THE ROYAL BANK OF SCOTLAND**

**Defendant/Respondent**

**-and-**

**THE FINANCIAL CONDUCT AUTHORITY**

**Intervener**

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**WRITTEN SUBMISSIONS OF THE**
**FINANCIAL CONDUCT AUTHORITY**

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