

# INVESTMENT SERVICES AND PROTECTION OF THE RETAIL CLIENT

Martin Hobza\*

**Abstract:** *The paper deals with selected legal instruments of protection of retail client in connection with provision of investment services in the financial market. The area of investment services is widely harmonized by European Law. The content of this paper is mainly categorization of particular instruments, their characterization and analysis of selected issues associated with their application. The paper focuses on analysis of the conduct of business rules. The effect of the most important rules is illustrated by the example of investment advice. Attention is also given to Private Law instruments of protection for the aggrieved investor in disputes with investment services providers. Within the paper the author presents several proposals that may help to increase the level of protection for retail clients. Certain problems are analysed based upon the example of the Czech Republic, the conclusions however can be applied also in other Member States, thanks to the harmonized regime of provision of investment services.*

**Keywords:** *investment services, retail clients, conduct of business rules*

## 1. INTRODUCTION<sup>1</sup>

The provision of investment services is an area thoroughly regulated by European Law. In order to ensure free movement of capital and freedom to provide services within the European Union, the legal mode of operation of investment services providers is harmonized, currently by MiFID<sup>2</sup> and national implementing legislations, in the near future mainly by MiFID II<sup>3</sup> and implementing legislation. Not only in the Czech Republic, the provision of investment services belongs amongst the areas with the highest level of regulation both within Financial Law<sup>4</sup> and in the context of the legal system as a whole. Declared basis of the extensive regulation is, together with protection of the capital market, the retail client protection<sup>5</sup>.

The aim of this paper is to analyse how far the existing and proposed regulatory measures, mainly from the area of conduct of business are able to contribute to achieving the declared objectives and further to propose several additional measures aimed to increase the level of client protection. Certain problems will be analyzed based upon the example

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\* Mgr. Martin Hobza, Faculty of Law, Charles University, Prague, Czech Republic

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<sup>2</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

<sup>3</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

<sup>4</sup> Investor protection (not only) in relation to the provision of investment services is classified as a part of Financial Law both by Czech and foreign legal doctrine. See BAKEŠ, M., KARFÍKOVÁ, M., KOTÁB, P., MARKOVÁ, H., BOHÁČ, R., NOVOTNÝ, P., KOHAJDA, M., VONDRÁČKOVÁ, P. *Finanční právo*. 6. vydání. Praha: C. H. Beck, 2012. 519 p. and BIRKMOSE, H., SØNDERGAARD, M., NEVILLE, A., SØRENSEN, K. E. *The European financial market in transition*. Alphen aan den Rijn: Wolters Kluwer Law & Business, 2012.

<sup>5</sup> See Rec. 31 MiFID: “One of the objectives of this Directive is to protect investors. Measures to protect investors should be adapted to the particularities of each category of investors (retail, professional and counterparties)”.

of the Czech Republic, the conclusions however can be applied also in other Member States, thanks to the harmonized regime of provision of investment services.

## 2. CATEGORIZATION OF CLIENT PROTECTION INSTRUMENTS

Already the preamble of MiFID and MiFID II foreshadows importance that the European regulation attaches to the protection of the client – the investor in the capital market. Under the term ‘client’ we understand any person, whether natural or legal, which the provider, primarily an investment firm, provides investment services or ancillary services<sup>6</sup>. The protection is assured by several categories of legal instruments.

The first such category of instruments is the client categorization<sup>7</sup>. Depending upon the nature of the subject in position of client and other circumstances, we distinguish between three main categories of clients<sup>8</sup>. These are professional clients, professional clients on request and retail clients. The investment services provider “(...) *is subject to different obligations, depending on the category into which each client falls*”<sup>9</sup>. A different approach to client categories is noticeable particularly in different range of information duties of investment services provider and fulfillment of other conduct of business rules. It is the category of retail clients which benefits from the broadest protection under the Directives.

In the Czech legal system, a good example may be the issue of ascertaining suitability or appropriateness of investment services provided pursuant to the provisions of s. 15h and 15i Act on Capital Market Undertakings<sup>10</sup>. While in case of retail clients, the provider of investment services bears considerable or even decisive part of the responsibility for the suitability or appropriateness of the service, in case of professional clients is in accordance with s. 2c Act on Capital Market Undertakings considered that such client has the expertise and experience corresponding to the services provided. Responsibility for investment decisions weighs in this case the client.

It can be stated that a differentiated approach to the protection of each category of clients is an essential prerequisite to the efficiency of the protection system, although the client categorization specified in the Directives may not necessarily reflect the most suitable categorization. For example M. Kohajda states that clients can be classified into three groups, i.e. retail (small) clients, clients with greater expertise and ability to manage their finances and clients for which financial market activities are the primary reason for their existence<sup>11</sup>. Perhaps the most problematic category of clients according to the Directives is the category of professional clients on request. Within this category, a certainly restricted autonomy of client is applied, not only an objective perspective. It would be inefficient

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<sup>6</sup> See Art. 4 (10) MiFID and Art. 4 (9) MiFID II.

<sup>7</sup> See Annex II MiFID and Annex II MiFID II.

<sup>8</sup> For the purpose of this article, the category of eligible counterparties is not taken into account.

<sup>9</sup> VEIL, R. *European capital markets law*. Oxford: Hart Publishing, 2013, p. 385.

<sup>10</sup> Act No. 256/2004 Coll., on Capital Market Undertakings, as amended.

<sup>11</sup> KOHAJDA, M. Vztah mezi pojmy “spotřebitel” v soukromém právu a “klient” v právu finančního trhu. In: Petr Mrkývka a kol. *DNY PRÁVA 2013 – DAYS OF LAW 2013: Část IX. – Interakce soukromého a finančního práva*. [online]. Brno: Masaryk University, 2014, p. 216. Available at: < [http://www.law.muni.cz/sborniky/dny\\_prava\\_2013/09\\_interakce\\_soukromeho\\_a\\_financniho\\_prava.pdf](http://www.law.muni.cz/sborniky/dny_prava_2013/09_interakce_soukromeho_a_financniho_prava.pdf) >.

and difficult to imagine that also towards professional clients, particularly financial institutions, the investment services providers would be obliged to fulfil an extensive information duty and detailed conduct of business rules.

The second category of instruments is a set of prudential rules, ensuring the protection of clients indirectly, by determining the requirements for quality of investment services provider and its internal processes. “*These prudential rules have important implications for investor protection by supporting the stability of the firm*”<sup>12</sup>. An example could be capital adequacy rules and rules of engagement of the investment firm under s. 9a and following Act No. 256/2004 Coll., on Capital Market Undertakings or rules for the protection of client’s assets, including the guaranty fund of investment firms. Important part of prudential regulation are the requirements for managers and directors of investment services provider.<sup>13</sup>

Provider complying with such requirements is eligible to enter into contractual relationships with the client without the risk of failure to meet contractual obligations due to internal problems, such as bankruptcy of the provider, inadequate organizational structure leading to misappropriation of client assets etc.

The third and, for the purposes of this paper, the most important area are the conduct of business rules along with the requirements for expertise of persons who deal directly with clients on behalf of the investment services provider. It is a relatively extensive set of rules, comprising especially of rules in the area of client communication, informing the clients and requesting information from the clients. The purpose of these rules is to contribute to the protection of the client by establishing minimum standards of expertise and care. These standards must be fulfilled by the provider, when dealing with the retail client.

### 3. CONDUCT OF BUSINESS RULES

#### 3.1 The loyalty principle

The structural element of a system of conduct of business rules is a general duty on the provider of investment services to act honestly, fairly and professionally in accordance with the best interests of the clients<sup>14</sup>. This conduct lies primarily, but not exclusively, in compliance with the rules laid down by the Directives<sup>15</sup> and national legislation. The mentioned duty, which is sometimes referred to as the loyalty principle<sup>16</sup>, should also be understood as an interpretative guideline, whenever the rule of conduct is not explicitly provided.

It is not easy to specify the set of rules, which must be complied with in order to fulfil the principle of professional care. I considered that the set includes both rules explicitly mentioned in the relevant articles of the Directives or the provisions of national legislation regulating the provision of investment services and duties arising from other legislation, and finally even non-legal rules of conduct in relation to the client and investment services provided.

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<sup>12</sup> MOLONEY, N. *How to protect investors: lessons from the EC and the UK*. Cambridge: University Press, 2010, p. 208.

<sup>13</sup> In case of investment firms see s. 10 Act No. 256/2004 Coll., on Capital Market Undertakings.

<sup>14</sup> See Art. 19 MiFID and Art. 24 (1) MiFID II.

<sup>15</sup> See mainly Art. 19 MiFID and Art. 24 and 25 MiFID II.

<sup>16</sup> In case of the Czech Republic see s. 11a and s. 15 Act No. 256/2004 Coll., on Capital Market Undertakings, as amended.

Breach of any duty explicitly provided will usually also result in violation of the loyalty principle. But also a conduct which in itself would not materialize any signs of anticipated breach the by Directive and the implementing legislation, might be found inconsistent with the loyalty principle, and therefore considered unlawful. The investment services provider shall, within its activities, continuously analyse not only whether his chosen methods and procedures meet the requirements imposed by the legislation, but also whether they are able to meet the standards of loyalty as a non-legal rule of conduct, which the Directive and national implementing legislation refers to and gives a binding effect. The loyalty principle as a specific legal term is to be understood as a set of professional standards for the sector, namely the principle of conduct *lege artis*<sup>17</sup> and its application is not solely to be restricted to the fulfilment of duties explicitly provided by the Directive or relevant national legislation.

The broad conception of the loyalty principle prevents the mere formal compliance with the Directive's limited range of duties, on the contrary, emphasizes the material correctness of the investment services provider's approach to the client and significantly contributes to the protection of the client. It is appropriate to emphasize the wide range of applicability of this principle, which, unlike the following duties, applies to the provider, when dealing with both professional and retail clients.

### 3.2 Investment services containing an advisory element

Increased measures for the protection of the client can be traced in the case of investment services containing an advisory element<sup>18</sup>. It is a clear trend, responding to the increasing importance of these services in the European financial market and increasing volume of assets that are invested as a result of providing this type of investment services. Particularly apparent is the mentioned trend in case of investment advice. Its regulation will significantly expand as a result of the MiFID II adoption.

The reason is the fact that in case of investment services containing an advisory element the retail client leaves a significant part of his own investment decision to the provider of investment services, thus becoming largely dependent on the provider's professional qualities. It is therefore necessary to ensure both sufficient expertise of persons that act on behalf of the provider and the quality of the advice itself, in the broadest sense of the word. In my opinion, the assessment criteria should be especially topicality, factual substantiation, clarity and suitability of the advice provided to the client.

Although the burden of ensuring the quality of the investment advice weighs considerably more the provider, we cannot ignore client's cooperation in form of providing conditions for the most suitable setting of parameters of the service provided. In order to adjust services to the client's requirements (*know your customer* principle), in accordance to MiFID and its implementing Directive<sup>19</sup>, the provider "(...) is expected to obtain the nec-

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<sup>17</sup> HUSTÁK, Z. et al. *Zákon o podnikání na kapitálovém trhu. Komentář*. Praha: C. H. Beck, 2012, p. 318.

<sup>18</sup> For the purposes of this paper, these investment services are Portfolio management and Investment advice within the meaning of Annex I., Section A (4) and (5) MiFID and MiFID II.

<sup>19</sup> See Art. 19 (4) MiFID and Art. 35 (5) Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

*essary information regarding a client's or potential client's knowledge of and experience in investment in order to ascertain the type of product best suited to his financial situation and his investment objectives in order to enable the firm to recommend suitable financial instruments*".<sup>20</sup>

The content of the mentioned areas is in the Czech legal order concretized in the statutory instrument.<sup>21</sup> There is no corresponding client's duty to provide the requested information. In case that information, whether due to the client, or for other reasons, cannot be obtained, the European legislation lays down duty on the provider of investment services not to recommend services or financial instruments to the client. The Czech legislation is probably beyond the scope of this requirement, when in the same case it also forbids to provide advice on investment instruments.<sup>22</sup>

MiFID II preserves above described regulation and at the same time specifies the scope of information that the service provider is obliged to obtain from the client. Emphasis is now placed particularly on client's ability to bear the loss and his risk tolerance (see Art. 25 (2) MiFID II). Clarification of the requested information can be considered as a positive step towards an increased individualization of the provided investment services and reducing the risk of provision of unsuitable services with negative consequences for invested assets.

It is obvious that the above mentioned duty on the provider not to provide unsuitable investment service significantly reduces the autonomy of both contracting parties. While in case of investment services without advisory element the regulation allows only to inform the client concerning the inappropriateness of the investment service provided<sup>23</sup>, in case of investment services including advisory element there is no such possibility. It can be concluded that despite explicitly warning the client concerning the unsuitability of the investment service or advice on investment instrument provided and client's express statement that he wishes to be provided with the services in this way and is aware of the unsuitability for his person, constitutes the provision of unsuitable investment services breach of the duty to act honestly, fairly and professionally in accordance with the best interests of the clients.

I consider such rules being too protective. Rather than by strict prohibitions, the legislation should improve the retail client's protection by extending the information duty, as does for example MiFID II in case of investment advice. In the case of express and informed consent of the client with the provision of investment service, which was, based on the provided information, considered unsuitable, such conduct should not be classified as unlawful. If the client insists, for example, on provision of investment advice to the shares, the provider should have a legal opportunity to satisfy the client, even if the shares will be evaluated as unsuitable for the investment<sup>24</sup>. In this case, I suggest constructing an information duty similar to the duty laid down in case of the investment services without advisory element and an informed consent institute.

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<sup>20</sup> VEIL, R. *European capital markets law*. Oxford: Hart Publishing, 2013, p. 385.

<sup>21</sup> See s. 27 Regulation No. 303/2010 Coll.

<sup>22</sup> See s. 15h (3) Act No. 256/2004 Coll., on Capital Market Undertakings, as amended.

<sup>23</sup> See s. 15i (3) Act No. 256/2004 Coll., on Capital Market Undertakings, as amended.

<sup>24</sup> For example due to high volatility.

The substance of this institute would be qualified consent with the provision of investment services despite being found unsuitable, granted by the client. The consent should be provided for each of the specific investment services or financial instruments. A prerequisite for granting of such consent would always be a previous evaluation of the suitability test under the loyalty principle. In case of a dispute with the retail client arising from investment services provided under the informed consent, the investment services provider would have to produce the informed consent to the court or supervisory entity.

On the contrary, in case the client refuses to provide information, or provides apparently incorrect information, I consider the current regulation completely suitable. To fulfil *know your customer* principle, when providing investment services including advisory element, the real knowledge of the client is necessary. Without that knowledge it is not possible to reliably set the parameters of the product and consider the risks. Current regulation in effect protects primarily the investment services providers and at the same time persuades clients to provide required information.

### 3.3 New protective provisions for investment advice

MiFID II further deepens the specific position of investment advice among other investment services. The aim of the regulation is to provide the client sufficient material enabling him to independently evaluate the most important parameters of the service. The provider is obliged to inform the client whether or not the advice is provided on an independent basis, whether it is based on a broad or on a more restricted analysis of different types of financial instruments and, in particular, whether the range is limited to financial instruments issued or provided by entities having close links with the provider, or other legal or economic relations, which are so close as to pose a risk of impairing the independent basis of the advice provided. The information shall also indicate whether the client will be provided a continuous assessment of the suitability of the recommended financial instruments.<sup>25</sup>

When providing investment advice it is also necessary to specify how the advice meets the personal characteristics of the client. If the provider informs the client that investment advice is provided on an independent basis, additional requirements will apply, in particular the assessment of a sufficient range of financial instruments and significant limitation of inducements.<sup>26</sup>

The new requirements in the subject area can be evaluated positively. Based on compulsory provided information, the client will be able to analyse the possible advantages and disadvantages of the product offered more independently. The increase of awareness of the retail clients is an instrument which, in my opinion, is along with the increasing of financial literacy of the clients capable to significantly contribute to reducing the undesirable conduct of investment services providers. *De lege ferenda*, I suggest to extend existing information duties also in the area of expertise and previous experiences of persons directly dealing with the client when providing investment services on behalf of the

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<sup>25</sup> See Art. 24 (4) a) MiFID II.

<sup>26</sup> See Art 24 (7) MiFID II.

provider. I believe that the information duty concerning education and previous experience of these persons will have a significant effect of self-regulation of the investment services providers and their staffing and will help to increase the level of the client protection against unqualified investment services.

#### 4. CONCLUSION: THE ROLE OF PRIVATE LAW IN THE AREA OF CLIENT PROTECTION

Hereinbefore analyzed existing legal instruments of client protection inherent to Financial Law are not, at least in itself, capable to ensure the intended high level of client protection. This conclusion can be illustrated on the example of recent market practice in the Czech Republic<sup>27</sup>. Although the new European regulation in MiFID II will, in my opinion, help to raise the standard of conduct of business at least in the area of provision of investment advice, it cannot be efficient in relation to the protection of retail clients without Private Law measures. The area of client protection is still legally viewed solely through the lens of the Public Law. If, however, the protective provisions are to be truly effective, it is necessary to provide the client with a legal instrument to ensure the easiest possible compensation on the Private Law level.

Not only in the Czech Private Law, has the protection of client of investment services been an underestimated topic for a long time. Neither MiFID, nor MiFID II “(...) *contains remedies empowering such investors to take action in those cases where an investment firm or credit institution does not comply with the conduct of business rules.*”<sup>28</sup> When the damage is caused by the provider of investment services due to a breach of duties imposed by Public Law, the client is referred to the standard Private Law instruments. Any by the supervisory authority inferred investment services provider’s liability for breach of protective provisions when dealing with clients has no direct impact on Private Law dispute between the provider and the recipient of investment services.

To prove deliberate violation of the legislation by the provider of investment advice or other providers of expert advice and information is often complicated. The Czech legislation attempts to solve the mentioned problem by establishing the so-called expert liability. Under the expert liability we understand liability of a person in the position of expert (including for example the investment services provider) for provided information or advice<sup>29</sup>. From the list of investment services, this liability applies obviously to provision of investment advice. Although this institute of national law appears to be a suitable tool for strengthening the rights of clients, in fact, its applicability is in my opinion rather limited. The burden of proof continues to lie on the aggrieved client, who must prove the provision of harmful, factually inaccurate or incomplete information or advice, in addition to the damage and the causality of course.

<sup>27</sup> See for example ČNB [online]. 2013. [2014-12-06]. *Ochrana spotřebitele a sankcionování finančních zprostředkovatelů*. Available at: <[http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/verejnost/pro\\_media/konference\\_projevy/vystoupeni\\_projevy/download/zamrazilova\\_20130867\\_tk\\_fin\\_zprostredkovatele.pdf](http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/verejnost/pro_media/konference_projevy/vystoupeni_projevy/download/zamrazilova_20130867_tk_fin_zprostredkovatele.pdf)>.

<sup>28</sup> CHEREDNYCHENKO, O. The legal matrix for retail investment services in the EU: where is an individual investor? In: DEVENNEY, J., KENNY, M. (eds.). *Consumer credit, debt and investment in Europe*. Cambridge: Cambridge University Press, 2012, p. 261.

<sup>29</sup> See s. 2950 Act No. 89/2012 Coll., Civil Code.

The solution for the outlined situation would be to adopt the reversed burden of proof in disputes arising from the provision of investment services<sup>30</sup>, whether at the level of European Law, or national legislation. In case of such dispute with a retail client, the provider would have to prove that there was no neglect of any duty provided by conduct of business rules in connection with the occurrence of the damage. It is clear that the proposed solution puts high requirements on the providers and their internal processes. However, if retail client's protection is being declared as one of the main objectives of the regulation of provision of investment services, these requirements seem to be justified. In my opinion, it is a combination of Public Law and Private Law instruments that will lead to more effective client protection and at the same time help to increase the standard of provision of investment services.

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<sup>30</sup> For a similar conclusion see CHEREDNYCHENKO, O. The legal matrix for retail investment services in the EU: where is an individual investor? In: DEVENNEY, J., KENNY, M. (eds.). *Consumer credit, debt and investment in Europe*. Cambridge: Cambridge University Press, 2012, p. 271.