



**By Christopher Kelman**

## **PROFESSIONAL NEGLIGENCE AND FINANCIAL ADVISORS**

Professional negligence relates to claims against a professional resulting from the professional's alleged negligence, or breaches of his fiduciary and/or contractual duties.

A financial advisor who provides advice on investments for reward has a legal duty to exercise such reasonable skill and care as is appropriate in the particular transaction. Liability of financial advisors for professional negligence can arise in contract, or in the torts of negligence or breach of statutory duty under the **Securities Act**. In addition, the financial advisor stands in a fiduciary relationship of trust and confidence with his client and can additionally be liable for breach of fiduciary duties.

The client of the financial advisor is oftentimes someone having very little knowledge of financial matters. Consequently, great reliance is placed on the financial advisor as someone possessing a highly specialized expertise. The

relationship is a reliance-based one in which loyalty, trust and confidence are attributes and this gives rise to fiduciary responsibilities. These fiduciary responsibilities prohibit non-disclosure, conflicts of interest, secret profits, unjust enrichment, among other unfair practices. The breaches of fiduciary duties do not constitute a separate cause of action however and form part of the adviser's tortious and contractual duties.

Reliance by the client on the advice given is essential in order to establish liability. Where there is advice but no reliance in making an investment decision, no liability arises if loss results from the investment. Consequently in one case where the first of several investments undertaken by the client was made some 14 months after the advice was given, the Privy Council held that the investor did not rely on the judgment of the bank in making the decision to invest.

### **THE STANDARD OF CARE AND SKILL REQUIRED**

The financial advisor holds himself out as possessing the necessary skill and competence to form a judgment in the subject-matter of the advice dispensed. In cases where his want of skill and competence is alleged, the questions that will arise for determination are:

- By what standard is the actions of the financial advisor to be judged, and

- Has the particular financial advisor met that standard?

It is now well-settled that the requisite standard of care is that which in the opinion of the Court represents the degree of skill and care ordinarily exercised by the reasonably competent professional financial advisor who has the same rank and specialization of the advisor in question. In tort, the Advisor is under a duty to advise with reasonable care and in contract he is under duty to advise with reasonable care and skill. The required standard of care is however the same in both. The setting of the standard (or bar) at that of the reasonably competent advisor signifies that while the advisor will not be judged against the highest standards of his profession, neither will he be judged by the lowest. What is reasonable care and skill will depend on all the circumstances prevailing at the time that the advice is given. In a case of professional negligence, the court will normally receive for guidance, expert evidence as to acceptable practice and procedures from persons having expertise in financial services. Ultimately however, the question whether the standard has been met will be one for the Court alone and it can, in an appropriate case, reject a generally accepted practice as failing to meet the required standard.

### **AVOIDING CLAIMS FOR PROFESSIONAL NEGLIGENCE- BEST PRACTICES**

There are a number of ways in which the Financial Advisor can avoid claims for negligent financial advice. A few of these safeguards are listed below.

❖ **Obtain clear and specific instructions at the outset preferably in writing**

The benefits of having a written agreement are obvious. It reduces the scope for misunderstanding between the parties. It offers clarity, certainty and specificity as well. Importantly, it allows the Advisor to expressly limit his potential liability in the event something goes wrong. An oral contract can contain a Disclaimer as effectively as a written one, but as with all oral contracts ascertaining its terms, including whether a Disclaimer was made or not, will be a matter of conflicting evidence by the parties. A written document on the other hand, will avoid the necessity of having to adduce evidence of what were the terms agreed, as the document will speak for itself.

❖ **Include Disclaimers of Responsibility in all client contracts**

In the case of **Hedley Byrne v. Heller** which established the principle of liability for negligent statements, the defendant bank was not found liable as the court held that its disclaimer of responsibility was effective to exclude its liability for negligence. Therefore Financial Advisors similarly by way of a Disclaimer of Responsibility and by the use of clear and unambiguous words, can exclude liability for negligence altogether, or at least limit its scope. It can also be limited to exclude liability for specific portions of the advice only, or liability to third parties who may come into possession of the advice. It is a good practice to include for instance in the Engagement letter a statement that a full explanation

has been given of the particular investment selected and the client understands the transaction and the implications and risks of entering into it and the decision to invest is his informed choice.

❖ **Know your client; give advice based on a full examination of his personal circumstances and particular financial situation**

Perhaps the Financial Advisor's most important responsibility is to know his client. He is obliged to give advice based on knowledge of his client's personal circumstances and financial situation. This will involve taking into account the client's level of education, intelligence, knowledge of finance and so forth. Advice should be given in terms which are appropriate to the comprehension and experience of the particular client. In relation to the client's financial position, an assessment of the client's income, assets, liabilities and disposable income is crucial in determining the critical matter of whether a person in the financial position of the client can reasonably afford to enter the proposed transaction. Advice which otherwise may not be negligent, may be determined to be negligent in the context of the financial situation of the client.

❖ **Ensure that the client understands the level of risk involved in the proposed transaction.**

This is another critical requirement. The higher the risk level, the greater the need for explanation of risk. Also, the more complicated the investment, the greater the need for detailed explanation. The investment risks must be explained in terms which the investor will understand (which can only be fulfilled based on an assessment of the investor's understanding level). ***The Securities (Conduct of Business) Regulation 1999*** (*the Regulations*) s. 8 (2) (d) imposes a requirement that the Request for Proposal completed and signed by each client must state whether the 'risk appetite' of the client is Aggressive/High Risk, Medium Risk or Conservative/Low Risk and each strategy employed by portfolio managers must fit one of these categories. It should be noted that by virtue of s. 3 of the Regulations, all licensees and their representatives must comply with all applicable requirements of the Regulations and s. 21 makes any contravention of the Regulations a criminal offence punishable upon conviction by both fine and imprisonment.

❖ **Avoid conflicts of interest**

A Financial Advisor stands in a fiduciary responsibility with his client. One of the effects of this relationship is the imposition of a duty on the Advisor to serve the best interests of his client at the expense of his own self-interest. This requires that the Advisor be independent from the investment products on which he advises and not stand to gain financially from any of his recommendations. At the very least, if he does stand to gain, his duties of honesty and good faith will oblige him to disclose his interest. A deliberate concealment will constitute a

breach of fiduciary duty. ***The Securities (Conduct of Business) Regulations 1999*** establishes Standards of Professional Conduct and cl. (1) (d) casts an obligation on Compliance Departments, which all Licensees must have, to ensure that transactions for clients or employers have priority over transactions in securities or other investments of which the licensee or registered representative is the beneficial owner.

❖ **Always undertake a thorough and independent review of investment products sold**

Apart from knowing his client, the Financial Advisor must also know his product. This is the only way that he can give reliable advice. The reliability of the particular advice is based on the reasonableness of the client to rely on it in determining his course of action. The advice rendered must be the product of the independent judgment of the Advisor; that is, independent of the product provider. It will not be a defence to a claim for negligent investment advice to say that the Advisor relied on the specialist knowledge of the product provider. The Financial Advisor can of course counterclaim against the product provider in the same claim for any negligent recommendations given, but ultimately he will have a separate liability to his client irrespective of what was told to him by the product provider. The competence of the Advisor to form an independent judgment can only be based on his comprehensive knowledge of the product. It is only when the Advisor understands the nature of the investment product he recommends and its attendant risks, that he can fulfill his duty of ensuring that the product

meets the needs and objectives of his client. The reasonably competent Advisor will for instance as part of his due diligence exercise, always investigate the history and structure of the fund, know the track record of fund managers, know the statistics of the number of investors in the fund, whether fund managers are persons of good repute, whether overseas investments are administered in a jurisdiction having a regulatory system and have legislation providing for an indemnity or compensation to investors in the event of insolvency.

In one case where an overseas fund collapsed in circumstances involving investors' monies not being invested the way they had been led to believe they would be and where two directors of the fund had previously been disqualified by the Companies Court, the Financial Advisor was criticized for not doing an internet search on the fund prior to recommending it.

It should be noted that under the *Securities Act* it is an offence punishable by imprisonment up to 10 years, to make a statement or disseminate information that is false and misleading in a material particular with the intention of inducing the purchase of securities if at the time the statement is made, the statement, or the person disseminating the information, knows or ought to have known that the statement is false or misleading in a material particular. Where the Financial Advisor recommends a product as suitable it has been argued that impliedly he represents (1) that he has carefully considered the nature of the investment, (2) he has also considered the client's needs and (3) the investment meets those

needs. If any of these implicit representations turn out to be false or misleading in a material particular, the Advisor may be liable under the Act.

❖ **Conduct of Financial Advisors which have been determined by the courts to constitute professional negligence**

- *Failure to properly assess the client's needs and financial situation and to properly classify client*
- *Failure to properly determine whether the client can afford the particular investment*
- *Advising Investment unsuited to needs of the client*
- *Failure to warn of risks associated with proposed investments*
- *Financial Advisor's pecuniary interests in a particular investment*
- *Reliance by the Financial Advisor on the negligent advice of a product advisor in recommending an investment product to his client*

**CONCLUSION**

The financial advisor can avoid claims for professional negligence if he acts reasonably and prudently. **The Securities Act**, for instance, provides that it is a defence for a person charged with any offence under the Act to prove that he took all reasonable precautions and exercised all due diligence to avoid commission of the offence charged. In my view, this will constitute a defence in contract and negligence claims as well.

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