Client re-categorisation rules: Key takeaways

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In the case involving Robert Tchenguiz (Applicant) and IG Index Limited (Respondent*) [2022] EWHC 793 (Ch)*, the re-categorisation of the Applicant by the Respondent from a retail client to an Elective Professional Client (EPC) was a pivotal issue.

The Applicant contested this re-categorisation, arguing that the Respondent failed to ensure compliance with the **qualitative and quantitative tests** for EPC status as required by Chapter 3 of the **Financial Conduct Authority's (FCA) Conduct of Business Sourcebook (COBS)** and did not adequately assess his eligibility under the FCA Rules. Had the Applicant remained a retail client he would be entitled to the "negative balance" protection, safeguarding against losses exceeding the initial investment.

According to the FCA rules, a firm is mandated to apply qualitative and quantitative tests before re-categorising a client as an EPC, as below:

- **Qualitative Test**: Ensures the client possess the requisite expertise, experience, and knowledge to make their own investment decisions and understand the risks involved.
- **Quantitative Test:** Assesses whether the client has engaged in trading with sufficient frequency or possesses significant experience in managing substantial financial portfolios or trading complex financial instruments.

The High Court of England and Wales, Chancery Division made significant findings in this case:

- The Respondent's approach to the qualitative test was appropriate and reasonable, considering the Applicant's MiFID appropriateness score, providing the necessary assurance of his competence to trade spread bets as an EPC.
- The Respondent's policies explicitly dictated the consideration of actual trading experience in relation to this test and outlined a scoring system based on the relative complexity of products traded.
- The Respondent took all reasonable steps to ensure the Applicant's compliance with the quantitative test.
- The Respondent adequately communicated the implications of the re-categorisation, including the loss of negative balance protection. The contract terms were clear, and the Respondent's actions in closing out the Applicant's positions due to insufficient margin were within its rights.
- The Applicant's claims of unfair treatment and breach of contract were dismissed, with the court affirming the Respondent's compliance with its contractual obligations.

Key Takeaways:

1. COBS re-categorisation rules are actionable solely as a claim for damages and not for contractual enforceability.
2. Firms should ensure the clarity and validity of their business terms, and the clients understand the risk associated with the transaction.
3. At all times, there should be clear and accurate communication with the clients and firms should ensure that the clients are provided accurate information in order to make an informed decision.
4. Firms' EPC policy and process should be unambiguously clear. The procedure should specify what experience is considered as the relevant measure used by the firm in relation to the qualitative test.
5. Under the qualitative test, the firms cannot be lax and rely on a client's self-certification of understanding risk. Also, theoretical knowledge of the client will not suffice.
6. Firms should meticulously follow all reasonable steps to ensure compliance with the qualitative and quantitative tests under COBS.
7. Firms must rigorously adhere to robust policies and processes when transitioning from retail to elective professional client status to effectively mitigate similar challenges.
8. Clear warnings should be provided regarding the potential loss of protection for professional clients.
9. Firms should maintain a clear audit trail and sufficient records to support client categorisation (to be retained for up to 5 years).

The ultimate duty of care rests with the Firm to ensure that the products and services offered by them are suitable for the client's risk tolerance and financial understanding.

If this interests you, FMConsult are happy to assist you with review and assess your systems and controls around COBS under the FCA handbook.

These are some of the areas that we can assist you with:

1. *SYSC (Senior Management Arrangement Systems and Controls) review*
2. *Client file review (including full life cycle of client)*
3. *Financial promotions review*
4. *Anti-Money Laundering Reviews; and*
5. *Training*

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