High Court rejects claim against regulated firm for alleged contravention of COBS

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The decision confirms (obiter) that whether breach of a particular FCA rule will make a transaction automatically void/unenforceable depends upon the correct categorisation of the rule(s) shown to have been contravened

The High Court has found in favour of an online spread betting company in its claim against a real estate tycoon for unpaid debts of £6.5 million following the close-out of a trading position in March 2020: *IG Index Ltd v Tchenguiz* [2024] EWHC 1880 (Comm).

The decision will be of interest to financial institutions for the court's *obiter* comments on ss.138D(2) and 138E of the Financial Services and Markets Act 2000 (**FSMA**). The judgment confirms the limited categories of regulatory rule breaches which will automatically make a transaction void or unenforceable. Outside of these limited categories, a customer may have a claim for damages for breach of statutory duty, but this may be subject to a number of potential hurdles, including arguments about causation and any contributory negligence on the part of the customer.

S.138D(2) establishes a statutory right for private individuals to seek damages if they suffer loss due to a breach of the Financial Conduct Authority's (**FCA**) rules by an authorised person. S.138E(2) of FSMA outlines certain limitations to the consequences of such a violation, in particular that breach of an FCA rule does not automatically render transactions void or unenforceable. However, s.138E(3) introduces a number of exceptions to this general rule.

In the present case, the defendant argued that he was not liable for the unpaid close-out debts on the basis that the company had incorrectly categorised him as an elective professional client (**EPC**), rather than a retail client, in breach of the Conduct of Business Sourcebook (**COBS**) 3.5.3R and 3.5.6R. He contended that this alleged breach automatically extinguished any debt that he owed to the company, given that as a retail customer he would have benefited from certain protections under COBS. The court found that the company had correctly categorised the defendant as an EPC and in doing so it had not committed any breach of COBS.

However, even if the company had contravened a COBS rule in its categorisation of the defendant as an EPC, the court found (*obiter*) that such a breach would not have made the transaction void or unenforceable, pursuant to s.138E(2) FSMA. Given that none of the exceptions to this general principle at s.138E(3) applied, the contravention (if there was one) would not extinguish automatically the defendant's debt. Accordingly, the defendant's only potential defence was one of set off against a

damages counterclaim under s.138D(2) FSMA. In circumstances where the defendant had not brought a counterclaim for loss allegedly suffered, the defence therefore failed and the defendant was liable for his unpaid debt.

The defendant has brought various different claims against online spread betting companies arising out of similar facts, as he held open positions with a number of firms which were all impacted negatively by the Covid-19 pandemic (see our previous blog post).

We consider the decision below in more detail.

Background

In December 2019, Mr Tchenguiz opened a spread betting account with the claimant spread betting company (**IG**) as a retail client, to take positions on the share price of a listed transport operator. Shortly thereafter, he applied for and obtained EPC status. This re-categorisation meant that Mr Tchenguiz did not have the benefit of Negative Balance Protection (**NBP**), a protection typically afforded to retail clients, preventing them from losing more than the funds in their account.

In March 2020, Mr Tchenguiz incurred significant losses and faced margin calls on his spread betting account, as a result of a sharp drop in the share price of the listed transport operator during the Covid-19 pandemic. IG subsequently liquidated his open positions and closed out Mr Tchenguiz's account, which left a close out balance of £6.5 million. Mr Tchenguiz failed to pay the close out balance despite repeated requests by IG to do so. IG consequently brought a claim against Mr Tchenguiz for the outstanding sums.

Mr Tchenguiz denied that he was liable, arguing that IG had incorrectly categorised him as an EPC and that he should have remained a retail client, which would have entitled him to certain protections, including NBP. He contended that IG failed to follow the correct procedure for re-categorising him as an EPC, as set out in COBS, specifically COBS 3.5.3R and 3.5.6R (the **Re-categorisation Issue**). This alleged breach of COBS meant that he should have remained a retail client, with the benefit of NBP (under COBS 22.5.17R), which would have limited his losses (the **NBP Defence**).

Decision

The High Court found in favour of IG. The key issues likely to be of interest to financial institutions are set out below.

The Re-categorisation Issue

The court found that IG had complied with its duty under the FCA's COBS 3.5.3R and 3.5.6R in re-categorising Mr Tchenguiz as an EPC.

The court noted that IG had taken all reasonable steps to ensure that Mr Tchenguiz satisfied the two tests required by COBS, before deciding to accept his request for re-categorisation as an elective professional client, known as the "qualitative" and "quantitative" tests. The qualitative test requires a firm to undertake an adequate assessment of the expertise, experience and knowledge of the client, whereas the quantitative test involves satisfying specific criteria (eg that the client has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged).

The court highlighted that there was no suggestion that IG's policy (set out in the EPC process and online procedure documents) was deficient. The online procedure document clearly stated that actual trading experience was the only measure that IG would use in respect of the qualitative test (and that the client's self-certification of an understanding of the risks or any theoretical knowledge would not be considered). IG's adherence to the online procedure document showed that IG took all reasonable steps in its assessment of Mr Tchenguiz's competence to trade spread bets as an EPC. The answers he gave provided IG with the reasonable assurance required by the qualitative test.

As to the quantitative test, the court was persuaded by IG's evidence that it had looked beyond Mr Tchenguiz's self-certification (as the 'Questions and Answers' document published by the European Securities and Markets Authority (**ESMA**) in relation to investor protection under MiFID II and MiFIR (**ESMA Guidance**) suggests when there is reason to doubt its conclusiveness). For example, IG evidenced its consideration of a previous High Court judgment arising from a dispute between Mr Tchenguiz and the Serious Fraud Office, highlighting his professional experience. This showed that Mr Tchenguiz had significant experience of contracts for differences (**CFDs**) and, consistent with the ESMA Guidance, IG was entitled to act upon that in concluding he had the required knowledge to trade products of comparable complexity as those identified in the account opening application (spread betting and CFDs). There was also no reasonable basis for IG to conclude that what Mr Tchenguiz said in the EPC application was manifestly out of date, incomplete or inaccurate and IG was entitled to rely on it. IG therefore took all reasonable steps to ensure that Mr Tchenguiz satisfied the quantitative test.

Finally, the court dismissed Mr Tchenguiz's case that he was not given adequate warning of the loss of NBP. The risk was flagged by IG in various documents, including the EPC application form, and there was no evidence that the warnings were deficient or misunderstood by Mr Tchenguiz (or any average applicant for EPC status).

Accordingly, the court found in favour of IG in its claim against Mr Tchenguiz.

NBP Defence

The court found that in light of its conclusion on the Re-Categorisation Issue, Mr Tchenguiz could not succeed on the NBP Defence. However, given that it had been fully argued the court considered it appropriate to address this issue as well.

The court noted that COBS 22.5.17R confers a NBP on retail clients, clearly providing that (in the judge's words) a retail client cannot lose more than the funds in his account. Assuming (contrary to the court's primary finding) that Mr Tchenguiz was correct on the Re-Categorisation Issue, the court considered whether IG's failure to comply with COBS 3.5.3R/3.5.6R meant that IG was not entitled to classify Mr Tchenguiz as an EPC, so that he remained a retail client with the benefit of NBP.

The question for the court was whether IG's contravention of COBS 3.5.3R/3.5.6R (if there had been one) and subsequent contravention of COBS 22.5.17R, made the transactions void or unenforceable. The court considered that this was a pure question of law.

To answer this question, the court considered s.138D(2) of FSMA (which provides a private person with a private right of action to pursue a firm for the contravention of an FCA rule), and s.138E (which sets out

limitations on the effect of contravening rules). A summary of the court's analysis of these provisions to the present case is set out below.

Alleged breaches of COBS 3.5.3R and 3.5.6R

The court noted that COBS 3.5.3R and 3.5.6R are FCA rules within the meaning of section 138D(2) FSMA.

However, s.138E(2) provides that a contravention of an FCA rule does not make a transaction void/unenforceable (subject to exceptions at s.138E(3)). IG cited a number of authorities demonstrating that, however egregious a firm's breach of a rule might be, if the rule is within the scope of s.138E(2) then any agreement which results from it is not void or unenforceable: *IG Index Ltd v Ehrentreu* [2013] EWCA Civ95*, Marshall v Barclays Bank plc* [2015] EWHC 2000 (QB), and *Marsden v Barclays Bank plc* [2016] EWHC 1601 (QB)).

In the court's view, it was clear that COBS 3.5.3R and 3.5.6R fell within the scope of s.138E(2), with the result that any contravention of those rules did not make the transactions in this case unenforceable. S.138E(3) provides certain exceptions to this general principle, listing categories of FCA rules where breach of the relevant rule would make the transaction void/unenforceable. However, the court held that COBS 3.5.3R and 3.5.6R did not fall within any of the exceptional categories set out at s.138E(3) FSMA.

Accordingly, Mr Tchenguiz's only defence would have been through a counterclaim under s.138D(2) for damages in respect of the contraventions (of 3.5.3R and 3.5.6R), giving rise to an equitable set off to extinguish/reduce the claim.

Mr Tchenguiz's failure to plead a counterclaim for loss allegedly suffered by him meant that this limb of his defence failed.

Alleged breach of COBS 22.5.17R

The court's analysis of COBS 22.5.17R was more complex, but it ultimately reached the same conclusion and was unpersuaded that Mr Tchenguiz would have succeeded in defending IG's claim without a counterclaim for damages for breach of COBS 3.5.3R/COBS 3.5.6R. In particular, the court observed:

- A counterclaim would have been required in respect of the contraventions of COBS 3.5.3R and COBS 3.5.6R, which are the necessary stepping-stones to any contravention of COBS 22.5.17R.
- COBS 22.5.17R is not a rule where the FCA has chosen to specify the consequences of a contravention (which it has the power to do under s.137D(7) FSMA).

As a general point, the court underlined that ss.138D, 138E(2) and (3) mean what they say. A customer will only have an absolute claim/defence on the basis that a transaction is void or unenforceable for breach of specific categories of FCA rules. Otherwise, a customer will only have a claim for damages for breach of statutory duty, which will be subject to a number of potential hurdles, including arguments about causation and any contributory negligence on the part of the customer. Accordingly, the categorisation of the rule(s) shown to have been contravened is important.

In light of the above, the court concluded that Mr Tchenguiz's case on the NBP Defence, indeed his defence generally in the absence of a counterclaim, failed because he was unable to point to the breach

of a rule in COBS falling within one of the categories set out at s.138E(3) FSMA, which would have the effect of making the transaction void/unenforceable.