Feature

KEY POINTS

- This article looks at the recent judgment in *Target Rich International v FXCM Limited* [2020] EWHC 1544 (Comm) in which:
  - It was held that the rules under FSMA 2000 in the Conduct of Business Sourcebook (COBS) effectively implemented the Markets in Financial Instruments Directive 2004/39/EC (MiFID).
  - Under English law, contracts with authorised entities do not in the absence of express words of incorporation incorporate the rules in COBS.
  - Authorised entities are not subject to a standard of care in the same terms as the rules in COBS.
  - The court explained the true meaning and effect of the "Best Execution Rule" in COBS 11.2.1R.

Author Francis Tregear QC

Pushing at a closed door? Another failed attempt to widen the scope of claims against FCA authorised entities

This article considers the recent decision in *Target Rich International v FXCM Ltd* [2020] EWHC 1544 (Comm) in which the court confirmed a string of recent decisions at Court of Appeal and first instance levels rejecting an argument that the COBS rules created contractual or common law obligations on the part of authorised entities. The recent case law considered shows that there is a series of cases in which the same arguments have been raised in an attempt to widen very radically the scope of claims that can be brought against FCA authorised entities.

The case of *Target Rich International v FXCM* is the most recent in a cohort of cases in which it has been argued that the COBS rules can and should form the basis for private law contractual and tortious liability on the part of authorised persons. This argument goes way beyond the limited scope of s 138D FSMA 2000 pursuant to which a private person may bring a claim for breach of statutory duty where an authorised person has contravened a rule. Another feature of the case is that the claimant also invoked EU law to support its claim.

The claim was a claim to recover losses sustained by Target Rich International (TRI) on its EUR/CHF positions after the Swiss "Flash Crash" which happened on 15 January 2015.

THE FACTS

FXCM provides an electronic, retail trading platform in the foreign exchange (forex) market. FXCM's platform provides access for all kinds of traders, from private individuals to companies, such as TRI, to global markets. FXCM is effectively a "mini exchange"; it gathers in market prices to buy or sell currencies from liquidity providers such as banks and other institutions. FXCM was regulated by the FCA and was bound by the rules in COBS.

TRI was a corporate vehicle for two Taiwanese nationals to speculate on forex. TRI's positions were concentrated in EUR/CHF and it was long on the Euro meaning that it was "betting" that the Euro would rise in value against the CHF.

When TRI opened a position with FXCM on a particular currency pair at the prices shown on the trading platform which included a disclosed mark-up, FXCM would then open a corresponding back to back position at a price which excluded the mark-up. The price differential between TRI's position and FXCM's position (the spread) would represent FXCM's profit on the particular transaction. TRI's positions were leveraged, meaning that for every unit of currency held on its account TRI could obtain exposure equivalent to a multiple of thousands. In this way substantial profits and losses can be made on relatively small movements in currencies compared to the margin deposited by the customer with FXCM.

The relative values of currency pairs in respect of which trades were placed change constantly and could change between the time an order is placed and the time it is executed even though the time lapse is measured in seconds. The contractual documentation provided a clear warning which explained that forex trading was risky, speculative and was only appropriate for persons who trade on margin who can afford to lose more than their margin.

The contractual documentation was carefully structured to take account of these characteristics of forex trading. For example, a Stop Loss Order (SLO) only gave rise to a binding transaction once it had been accepted and executed by FXCM. This was to meet the possibility that a price could change rapidly and the precise price triggering the Stop Loss Order might well not be achievable because of continued movement in the quoted price of a currency pair.

On 15 January 2015, TRI's trading position was that it had "long" positions on EUR/CHF – ie it expected the Euro to strengthen against the Swiss Franc (CHF). Its total exposure was about US$3,600,000. It had SLOs pursuant to which the positions should be closed by FXCM if the Euro weakened against the CHF to 1.17911 but, as explained, the price at which the position would be closed under a SLO could not be guaranteed.

To understand the context, it is necessary to analyse TRI's positions. The positions were long EUR/CHF. Each position was one in which TRI was buying Euros at a price expressed in

CHF and anticipated being able to sell later at a higher price in CHF. The Euro side of the equation (the base currency) represents 1 unit and the CHF side of the equation represents the corresponding CHF price.

Closing the position involved the reverse transaction, ie selling Euros at a price expressed in CHF. Loss or gain depends on the relative movement of the CHF as against the Euro. The gearing pursuant to which TRI was able to take a position which was a high multiple of the cash in the account magnifies both the gain and the loss.

For some years before 15 January 2015 the policy of the Swiss National Bank (SNB) had been to ensure that the value of the CHF should be capped as against the Euro at CHF 1.20 in order to facilitate Swiss exports to the EU. For as long as this policy endured there was a "floor" to the value of the Euro as against the CHF which was guaranteed by the SNB. To avoid the CHF becoming overvalued against the EUR the SNB was a major buyer of EUR for CHF.

THE "FLASH CRASH"

Unexpectedly, on 15 January 2015 at 8.30am Central European Time the SNB announced that it was removing the cap on the CHF. The announcement caused the Euro to collapse suddenly and catastrophically against the CHF. Within 43 seconds of the announcement being made the value of the Euro had fallen through the SLO prices and within 90 seconds the Euro and CHF were at parity. As well as the collapse in value, there was a collapse in liquidity and usual levels of offers to meet FXCM's sell positions collapsed.

FXCM's system had "circuit breakers" which stopped trading and pricing when aberrant prices were detected in the market. TRI's positions were not closed at the SLO price, the circuit breakers stopped trading for a period and by the time the positions were eventually closed, TRI claimed to have sustained losses of US$600,000. It held FXCM responsible for breach of the best execution rule in COBS, breach of contract and breach of duty.

At first, TRI complained to the Financial Ombudsman which rejected the complaint. TRI then complained to the FCA about its failure properly to supervise FXCM and sought an order for compensation under s 348(1) FSMA 2000. This was refused.

TRI's claim was based on:

(i) breach of the best execution rule in COBS 11.2.19R: "Whenever there is a specific instruction from the client, the firm must execute the order following the specific instruction" which was also a breach of contract on the basis of TRI's case that the COBS rules were expressly or impliedly incorporated into the contract;
(ii) breach of implied terms based on the contract which reproduced the best execution rule. The basis of implication was "necessity" or the view of the "officious bystander" that it was obvious that COBS rules should be implied into a contract with an authorised entity;
(iii) breach of duty based on common law duties which tracked the alleged express and implied contractual terms.

The basis for TRI's argument that the best execution rule was incorporated into the contract was essentially:

(i) as a matter of EU law in order to give effect to MiFID (MiFID case);
(ii) that the COBS rules gave rise to a duty of care which is co-extensive with the rules, (Duty of Care case);
(iii) by express incorporation (Incorporation case); and
(iv) by implication (Implication case).

The background to these arguments are that it is only in limited circumstances that a private law claim can be made on the basis of a breach of a rule. Under s 138D FSMA 2000 a right of action for breach of a COBS rule is accorded only to a "private person". For the purposes of a corporate claimant such as TRI, under reg 3 of the FSMA 2000 (Rights of Action) Regulation 2001 a "private person" includes "any person who is not an individual, unless he suffers the loss in question in the course of carrying on business of any kind". In *Titan Steel Wheels Ltd v RBS* [2010] 2 Lloyds Rep 92, David Steel J held that s 138D should be broadly interpreted so that it excluded companies carrying on business of any kind. Therefore, s 138D provided no basis on which TRI could claim. Therefore, having failed with the administrative remedies route, TRI thought it needed to argue that the contract contained the best execution rule.

THE MiFID CASE

The MiFID case was that the COBS rules were to be implied into every contract with an authorised entity carrying out investment business and that the same duties were owed in tort. It was based on a ruling of the CJEU on a reference from the Court of First Instance in Madrid in *Genil 48 SL v Bankinter* [2013] Bus LR 1132. The CJEU explained "… although article 51 of Directive 2004/39 provides for the imposition of administrative measures or sanctions against the parties responsible for non-compliance with the provisions adopted pursuant to that Directive, it does not state either that the member states must provide for contractual consequences in the event of contracts being concluded which do not comply with the obligations under national legal provisions transposing article 19(4) and (5) of Directive 2004/39, or what those consequences might be. In the absence of EU legislation on the point, it is for the internal legal order of each member state to determine the contractual consequences of non-compliance with those obligations, subject to observance of the principles of equivalence and effectiveness …".

TRI relied on the words "subject to observance of the principles of equivalence and effectiveness" to argue that any transposition of MiFID into English law had to provide for effective enforcement of rights for breach of obligations under MiFID. The only way to achieve that was to provide that those obligations should take the form of contractual obligations. This argument found support in a collection of essays published as *Agency Law in Commercial Practice* (OUP 2019) in which the view was expressed that any contractual provision that was less stringent than MiFID could not be applied. Therefore, to the extent that the contract was less "stringent" it was unenforceable.

This argument was rejected because it was incompatible with a series of decisions in England and Scotland.

The court considered *Grant Estates Ltd v RBS* [2012] CSOH 133 (Lord Hodge) which involved a swap mis-selling claim in which

Feature

Biog box
Francis Tregear QC is a barrister practising from XXIV, 24 Old Buildings, Lincoln's Inn London WC2A 3UP and Geneva. Email: francis.tregear@xxiv.co.uk

breaches of rules in COBS and MiFID were alleged. The Bank's contract provided that in the event of conflict between the contract and the applicable regulations, the regulations should prevail. The claimant argued that the regulations were thereby incorporated and further that the s 138D distinction between individuals and companies was not authorised by MiFID and should be construed in a manner compatible with EU law. It was also argued that *Titan Wheels* was wrong. Both arguments failed.

So far as EU law was concerned, Lord Hodge held at [48] that MiFID did not require a member state to provide protection to a customer by means of a direct cause of action against the authorised person. The passage cited above from *Genil* makes it clear that Art 51 of MiFID required the imposition of administrative measures rather than contractual consequences. It is clear that FSMA 2000 provides for such administrative measures – see ss 205, 206, 382 and 384 which are available to individuals and companies. TRI unsuccessfully invoked those administrative measures to recover compensation before making its claim against FXCM.

Even if TRI's MiFID case had been well-founded it would not have had the effect of making the COBS rules contractual terms. In all likelihood it would have enabled TRI (and other claimants in the same position) to bring a claim against the UK government in accordance with the principles of *Francovich v Italy* (1991) C-6/90. This decision of the European Court of Justice established that member states could be liable to pay compensation to individuals who suffered a loss by reason of the member state's failure to transpose an EU directive into national law.

Ultimately, it was the terms of MiFID itself as articulated by the CJEU in *Genil* that undermined TRI's argument and supported by *Grant Estates*, the court had no hesitation in rejecting this argument.

THE DUTY OF CARE CASE

TRI argued that where failure to comply with a regulatory obligation was likely to give rise to damage to the counterparty a duty of care arises at common law which is co-extensive with the regulatory obligation. This argument was rejected as being inconsistent with the Court of Appeal decision in *Green & Rowley v RBS* [2013] EWCA Civ 1197 in which the court rejected a similar argument saying at [23]:

> "Mr Berkley's argument is misconceived. It amounts to saying that the mere existence of the COB Rules give rise to a co-extensive duty of care. This proposition invites the question 'Why?' … Parliament has provided by section [138D] a remedy for contravention of the rule … there is no feature of the situation which justifies the independent imposition of a duty of care at common law … ."

THE INCORPORATION CASE

TRI observed that the contractual documents contained multiple references to the FSMA regulatory regime and provided that it should take priority in the event of any conflict with the contract. On that basis it was argued that the COBS rules had been incorporated expressly into the contract or the contract "assumed" that they were binding. Reliance was placed on cases in which a background set of rules has been held to be incorporated into an agreement by the use of express words. In *Larussa-Chigi v CS First Boston* [1998] CLC 277, Thomas J held that a document which stated that transactions would be "governed by" a Code of Conduct achieved the incorporation of that Code. And in *Brandeis (Brokers) Ltd v Black* [2001] 2 Lloyds Rep 359, an agreement which was said to be "subject to" regulatory rules was held by Toulson J to have the same effect.

This argument was rejected on the basis that as a matter of interpretation there were no words of incorporation and it was unsurprising that a contract with an authorised entity should refer to and give priority in cases of conflict to the regulatory regime.

In relation to this argument the judgment also referred to other cases in this cohort including *Bailey v Barclays Bank plc* [2014] EWHC 2882, *NRAM v McAdam* [2015] EWCA CIV 751 CCA and *Thornbridge Ltd v Barclays Bank plc* [2015] EWHC 3430. The judgment also refers to an important judgment of Waksman J in *Flex- E- Vouchers Ltd v RBS* [2016] EWHC 2604.

THE IMPLICATION CASE

TRI's argument was rejected on the basis that the contract was perfectly workable without the implication of the COBS rules. So far as the "Officious Bystander" test was concerned, this had been rejected in similar circumstances by Waksman J in *Flex-E-Vouchers* who held that the argument did not even pass the summary judgment test applying the principles in *Marks & Spencers v BNP Paribas* [2016] AC 742.

BEST EXECUTION RULE

The judge considered that TRI had misunderstood the effect of the rule. At [113-119], referring *Forsta AP-Fonden v BNY Mellon* [2013] EWHC 3127, he explained that the rule was not concerned with when a legal obligation to execute arose but with the mechanics of execution once such an obligation arose. Noting that there was scope for confusion in the drafting of COBS whether a "specific instruction" created an obligation the judge confirmed that the rule was concerned only with mechanics and any special instruction that might have been given as to such mechanics.

On a proper understanding of the rule, he concluded that TRI would have lost the case even if COBS had been incorporated into the contract.

CONCLUSION

The cases reviewed in *Target Rich* suggest that there is a cohort of cases in which similar arguments are being raised in order to try to get around the fact that the COBS rules lack contractual force. Even if the court had been persuaded that the best execution rule was to be treated as being a contractual term TRI's claim would still have failed. ■

Further Reading:

- Private enforcement under MiFID II and MiFIR (2017) 8 JIBFL 485.
- How regulation impacts the interpretation of contracts (2017) 6 JIBFL 335.
- LexisPSL: Practice Note: MiFID II conduct of business and investor protection requirements.