Feature

KEY POINTS

- A breach of statutory duty Financial Services Authority (FSA) rules by the firm does not make the transaction void or unenforceable. The client has to show that the breach caused him loss.
- The firm will not be liable under s 20(3) of the Financial Services and Markets Act 2000 (FSMA) for giving advice without authorisation unless it advises on the merits of buying or selling a "particular" spread bet.
- Where the terms of business clearly provide for an execution-only relationship the client will struggle to persuade the court that casual remarks on the telephone should be treated as trading advice.

Author Alexander Pelling

The long and the short: common issues in spread betting cases

In this article Alexander Pelling considers the classic legal issues in spread betting cases.

WHAT IS SPREAD BETTING?

A spread bet is a form of contract for differences. The client agrees with the firm where he holds his account that each will pay to the other a specified sum per point (the stake) in respect of movements in a nominated index. In financial spread betting the index could be the FTSE 100 or the Dow, or the price of an individual share such as BP or, conceivably, a much smaller floated company, or the price of a commodity or a rate of exchange between specified currencies. If the client is "long" the firm will pay him the stake multiplied by any increase in the index value between opening and closing, but he will have to pay the firm on the same basis if there is a decrease. If he is "short" the opposite applies. The "spread" is the difference between the long and short, or "buy" and "sell" prices at any given time. Spread bets generally have expiry dates built into them but the client is able to close his position before expiry if he chooses to do so. The firm, however, does not have the same discretion. The firm generally, but not always, hedges the client's exposure in the underlying market. For a helpful summary of spread betting see the judgment of Rix LJ in *Spreadex Limited v Battu* [2005] EWCA Civ 855 at [2]-[4].

Not all spread betting is on financial indices. Spread betting markets are made by firms on a huge breadth of sporting events, although in this country anecdotal evidence suggests that the biggest individual positions are still taken on financial indices. In this regard spread betting offers certain advantages over more orthodox financial instruments when it comes to profiting from market movements. First, profits on spread bets are taken free of capital gains tax. Secondly, the "geared" or "leveraged" nature of spread bets means that typically the client only has to put up a fraction of the total cost of a position, which means that he can get bigger exposure for a given sum (in hedging the exposure the firm puts up the balance of the cost from its own resources). Thirdly, spread betting offers the client the opportunity to go "short" if he thinks that the market will fall – something that is not always available with a more straightforward brokerage.

The money that is won and lost on spread bets appears to have increased substantially over the past ten years. Certainly the sums at stake in litigation have gone up. The market falls of 2008 led to claims of up to £5m on a single account being issued through the courts. However, the size of the sums at stake does not deter clients who have lost money from seeking to be treated as helpless victims in litigation. For example, one defendant who had previously achieved trading profits in excess of £1m without depositing any cash of his own tried to persuade the trial judge that when the market moved against him he was "like a 'rabbit caught in the headlights' and was not able to exercise rational judgment and did not have control of his own decisions" (see *Spreadex Limited v Sekhon* [2008] EWHC 1136 at [17]). Morgan J held that he was "experienced and knowledgeable in spread betting" (*ibid*, [18]) and rejected his evidence as "self serving" (*ibid*, [178]). However, some judges are more receptive to this kind of presentation, and one or two have shown distinct suspicion of the firms. For example, some years ago one judge described spread betting in court as a "pernicious business" while submissions were being made. It is thus a normal characteristic of spread betting disputes that the client seeks to portray himself as a hapless ingénu lured by smooth-talking salesmen into a hazardous and incomprehensible world of cut-throat trading, while the firm emphasises the client's knowledge, experience and (frequently) profits prior to incurring the loss giving rise to the claim.

ISSUES IN SPREAD BETTING CASES

Rights under certain contracts for differences are enforceable at law under s 412 of the Financial Services and Markets Act 2000 (FSMA). There is Court of Appeal authority that financial spread bets are within the scope of the section (see *City Index v Leslie* [1992] QB 98). There is also High Court authority that spread bets on sporting indices are enforceable at law (see *City Index v Sadrik*, unrep, 21 October 1991). Many disputes are essentially contractual. There is, however, no standard set of terms and conditions used by the spread betting industry, so each case turns on its own documentation. Moreover, the disputes can also involve allegations of breach of statutory duty.

Most, although not all, spread betting claims are initiated by the firm. In a typical case the client's position has been closed out by the firm when it was losing money and the client did not have sufficient cash in his account to cover his obligations to the firm. Frequently, the firm will have made a margin call, demanding payment of the cash shortfall before closing the position. There may have been discussions about meeting the margin call before the position was finally closed out. Afterwards the market may

have "bounced" so that the client's position, but for the closure, might have resulted in a smaller loss or even a profit. Thus, the typical action will be a debt claim for the cash shortfall post-closure.

Counterclaims are normal. If the market "bounced" the client might say that his position should never have been closed, because the margin call was defective or he was given insufficient time to pay, or he reached some ad hoc agreement about payment that the firm subsequently broke. The client might also say that the loss was caused by the firm, because it failed to warn him of the risks associated with spread betting or otherwise failed to comply with its statutory obligations under the FSA's rules. He might even say that the firm gave him advice on his positions despite not being authorised to do so, but that the advice turned out to be wrong. These objections are considered in more detail below.

UNAUTHORISED CLOSURE

If the firm has effected a forced closure of the client's position it is essential for the firm to justify it by reference to the terms of the contract. If the firm cannot justify the closure, it has no claim to the debt. In *Spreadex Ltd v Battu* [2005] EWCA Civ 855, a somewhat technical case about the calculation of the firm's entitlement to margin, the court found against the firm on the basis of the "haphazard" use in the contract of terminology associated with margin, as a result of which it demanded more money than its entitlement and had no right to close. The court observed that: "If there was doubt [as to the contractual justification for closure] ... it would have to be resolved against Spreadex, who seek on the basis of their own terms...to close their clients' bets without their clients' authority."

Firms also have to be careful how they deal with clients who are in financial difficulty. In another case, *Cantor Index v Shortall* [2002] All ER (D) 161 (Nov), the claimant was liable to the client for duress/intimidation where it prevailed on the client to agree to closing of bets before the time for providing a margin had expired. The court held that the client was entitled to avoid the closure upon obtaining legal advice some two months after the closure.

Some firms have now adopted terms that entitle them to close a client's positions whenever the account is in overall deficit, whether or not they have made a margin call. Such terms, if clearly drafted, may obviate the need for margin calls. However, in *City Index Limited v Stevenson* (Unrep, 6 November 2001) it was held in the Chancery Division that a clause entitling the firm to close out the client's position without demanding margin potentially fell foul of the Unfair Contract Terms Act 1977 on the ground that it was "too stringent and not fair and reasonable". Whether a court would reach the same view now that the internet makes it straightforward for clients to monitor their accounts and positions wherever they are, is uncertain.

> "Some firms have now adopted terms that entitle them to close a client's positions whenever the account is in overall deficit."

In other cases the client has claimed in respect of trading loss because the firm *failed* to close out his positions for failure to meet a margin call for five days (see eg *Spreadex v Sekhon* [2008] EWHC 1136, esp [144] and *IG Index PLC v Max Leung-Cheun & ors* [2011] EWHC 2212). The origin of the obligation to close after five days was the old Conduct of Business Rule (COB) 7.10.5, which ceased to apply on 1 November 2007 (see below). However, there may be more cases like *Leung-Cheun* in which the obligation to close out within five days had found its way into the firm's terms of business and, accidentally or not, survived the removal of COB.

CLAIMS FOR BREACHES OF FSA RULES

Under s 150 of FSMA the client has a right of action against an authorised person (ie a firm) who causes him loss by breaching FSA rules. For practical purposes the FSA rules are those in the *Conduct of Business Sourcebook* (COBS) published on the FSA's website: there is no right of action for a breach of the rules regulating *approved* persons, APER (Approved Persons Principles and Code of Conduct) (see *Wilson & anor v MF Global UK Ltd & anor* [2011] EWHC 138 at [11]). A breach of COBS does not, however, make any transaction void or unenforceable (see FSMA s 151(2)). In *Wilson* Eady J held that for a claim under FSMA to succeed "the causal link has to be established between the failure and the loss" in that the claimant must show that "the supposed breach...led to a different and more adverse outcome than would otherwise have occurred" (at [19]-[20]). It is therefore not enough for the claimant to point to some breach of FSA rules and demand that his trading losses be reversed: he has to show that the breach caused the losses.

COBS provide for classification of clients into two main categories: "retail clients" and "professional clients". Before 1 November 2007, when the old COB was replaced by COBS, the broadly corresponding classes were "private customer" and "intermediate customer". Under COBS retail clients have protections that do not extend to professional clients. For example, money held by the firm for a retail client must be held in a trust account while it may mix the money of professional clients with its own money. For an extended analysis of the implications of this in an insolvency context see *In Re Global Trader Ltd (In Liquidation)* [2009] EWHC 602.

However, a firm may only classify an individual client as an "elective professional client" if certain criteria are met and it follows procedures designed to ensure that only people of sufficient financial knowledge and experience are classified as "professional clients" (COBS 3). In relation to the old COB rules, where the firm's classification was challenged it was held that the test was

Feature

Biog box
Alexander Pelling is a practising barrister at XXIV Old Buildings, Lincoln's Inn, London.
Email: alexander.pelling@xxiv.co.uk

whether the firm has taken reasonable care to determine that the client had sufficient experience and understanding to be classified as an intermediate customer (see *Spreadex v Sekhon* [2008] EWHC 1136 per Morgan J at [128] and *Wilson*, per Eady J at [24]). The equivalent test now appears to be whether the firm has complied with the procedural requirements set down in COBS 3.5.3, including that it assess and warn the client of the protections he stands to lose. If it has not done this it may not treat the client as professional and will potentially be liable to him if it treats him in a manner inconsistent with his status as a retail client.

RISK WARNINGS/APPROPRIATENESS

One of the most important protections afforded to retail clients is the firm's obligation under COBS 10 to assess appropriateness before it enters into a spread bet with him, and to warn him if it regards spread betting as unsuitable for him. This replaced the former obligation under COB 5.4.3 to take reasonable steps to ensure that the customer understood the nature of the risks involved in spread betting before it allowed him to trade. However, where the client was already an experienced trader of spread bets before 1 November 2007 there is no obligation to assess appropriateness merely because he has continued to trade since that date – see COBS 10.4.3. Even if the firm fails to assess appropriateness when it should do so, the onus will still be on the client to demonstrate that an assessment would have resulted in a warning that he would have heeded, and thereby avoided loss. In *Wilson* Eady J said (at [121]) that it would not be possible to establish causation in relation to a claim based on failure to provide a risk warning notice where the client's own evidence was that he would not have read any such notice if it had been provided.

ADVICE

The clients of spread betting firms frequently place trades over the telephone and are also able to obtain information about the market in the same way. Clients who owe money have sometimes tried to blame their losses on bad advice given in the course of such conversations. Spread betting firms are generally not authorised to provide advice or, if they are so authorised, they generally conduct spread betting on an execution-only basis and their terms of business make that clear. If the firm is not authorised to provide advice, but nonetheless does so, the customer has a right of action under s 20(3) of FSMA (see FSMA (Rights of Action) Regulations SI 2001/2256). If it is so authorised it can be liable if in breach of COBS 9 it makes a personal recommendation without first taking reasonable steps to ensure that the bet in question is suitable for the client. In *City Index v Balducci* [2011] EWHC 2562 (Ch) Proudman J held that COBS 9 does not apply unless the firm is authorised to make personal recommendations (see [28]-29]).

In *Balducci* the firm was not authorised to provide advice at all. However:

> "The onus will still be on the client to demonstrate that an assessment would have resulted in a warning that he would have heeded."

"[Mr Balducci] would call the trading desk several times a day to check on market trading prices. He was given the prices, together with general comments about the market, rather than advice about particular bets. He asked many questions and got general answers about whether the market...was going up or down, and about the behaviour of investors. [49]"

Proudman J saw generalised comments of this nature as falling short of actionable advice. She regarded it as material that "[n]othing was said about the timing of any investment by Mr Balducci or the size of any exposure" [49]. This observation gives due weight to the fact that the firm will not be liable under s 20(3) unless it advises on the merits of buying or selling a "particular" spread bet (see FSMA (Regulated Activities) Order SI 2001/544, Art 53). Comments to the effect that the market looks strong or weak are unlikely to fall into this category.

Proudman J referred to the judgment of Eady J in *Wilson*, in which the client argued that, although the firm's terms of business provided for an execution-only relationship, in the course of conversations between him and the firm's trading desk a *de facto* advisory relationship arose, but that the advice given was different from the advice that *should* have been given. Eady J held that, given the terms of business, there was an "air of unreality" about this contention (at [88]). He said:

"It is clear from the conversations that there was a good deal of banter and light-hearted badinage and,...it is clear to me that what was happening can best be characterised as exchanging information and 'bouncing ideas' off each other or swapping hunches about the market. Much of it was spontaneous and off the cuff. It would be unfair and unrealistic to pick upon certain passages in [the firm's employee's] observations, with six or seven years of hindsight, and to conclude that he had suddenly changed into 'advice mode' and was undertaking an obligation, on his own initiative, to give advice on behalf of his employers...If such conversations were to be subjected regularly to analysis of that kind with a view to changing the express terms of the parties' relationship, brokers would not be able to operate and communications would soon be drastically curtailed." (at [96])

This indicates that where the terms of business clearly provide for an execution-only relationship the client will struggle to persuade the court that casual remarks on the telephone should be treated as trading advice. That, however, is unlikely to prevent "advice" cases being run by clients who owe money that they are disinclined to pay. ■