DRN-3816547

The complaint

Mrs C and Mr Y complain that City Credit Capital (UK) Ltd (CCC) allowed them to trade Contracts for Differences (CFDs) even though it wasn't appropriate for them. They also complain that it should've warned them that trading CFDs wasn't appropriate. They say that if they had known this they wouldn't have gone ahead with the application and wouldn't have lost so much money.

What happened

In 2016 Mrs C and Mr Y approached CCC to open a CFD trading account with it. They were clients of an unregulated agent in their country of domicile who introduced them to CCC and the unregulated third party they'd eventually choose to manage their account. They filled out an application form in which they declared:

- They were domiciled overseas;
- They had no experience trading shares or trading leveraged products;
- They felt able to assess the risks involved in trading CFDs;
- They were after capital growth;
- They were intending on giving control of the account to a third party with power of attorney.

On 14 June 2016 they received a letter via email from CCC confirming that their account had been reviewed and they 'met the requirements to open an account'. At the same time as this letter they also received an 'additional risk disclosure' letter. This said:

'We have reviewed your application and have noted that you have limited/ or no experience in trading derivatives. In light of this, we need to draw your attention to our Risk Disclosure Statement (attached) to ensure that you fully understand the risks involved in trading derivatives. You should not deal in derivatives unless you understand their nature and the extent of your exposure to risk'.

CCC said that if Mrs C and Mr Y required further assistance, there were other options they could explore such as a demo account, 'seeking advice from a 3rd party' or 'appointing a Limited Power of Attorney'. The letter concluded by saying that these were only suggestions' and that if Mrs C and Mr Y still wanted to go ahead, CCC 'would be happy to accept your application upon receipt of the fund'.

Attached to this letter was a Risk Disclosure Statement. This notice outlined some very specific risks including:

- CFD trading on futures had specific risks around settlement and contingent liabilities which investors needed to be aware of;
- Some off-exchange markets were illiquid or exposed investors to the risk of being unable to close or manage their positions;
- Foreign markets could carry greater risks than the UK market, in addition to the foreign exchange rate risk which would also apply.

- Commissions might be payable, so an investor needed to be aware of what charges might apply – although CCC did not charge any commission itself.
- On occasion it might be difficult or impossible to liquidate a position as a result of volatile movements in price or at times when the relevant exchange suspends or limits trading.
- Clearing house protections may not apply.
- Insolvency of the firm with which the deal was being made, or any other brokers involved in the trade, might cause a position to be closed without the trader's consent.
- Electronic trading carried its own specific risks which the investors needed to be familiar with.

In the terms and conditions document, a number of schedules were also attached – including one specific on risk. This explained that foreign exchange spot contracts carried a number of risks, including that it is 'possible to lose more than your initial investment' and that sudden market movements might require the trader to 'deposit a substantial amount of additional margin funds, on short notice, in order to maintain' the position. In addition, CCC explained that the 'leverage often available in FX trading means that a small margin can lead to large losses as well as gains'. Similar risks were set out in the next section of the terms which covered CFDs.

Mrs C and Mr Y deposited around $131,202 between September 2016 and October 2016. Their account was managed by two unregulated third parties and suffered a substantial loss of funds – in May 2020 Mrs C and Mr Y were only able to withdraw just over $71. So they complained.

CCC looked into their concerns but didn't think it had done anything wrong. It said that it had never recommended a specific third party to trade on their account – it concluded this had been Mrs C and Mr Y's decision. And it said that it had complied with the regulations by sending them the additional risk disclosure notice following the appropriateness assessment it carried out.

Mrs C and Mr Y remained unhappy and referred their complaint to this service. I issued a provisional decision in October 2022. In it I said:

In 2016 the Conduct of Business Rules (COBS) written by the Financial Conduct Authority (FCA) set out very clearly the process which CCC needed to follow. In short, COBS 10 required CCC to 'ask the client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product of service offered or demanded so as to enable the firm to assess whether the service or product envisaged is appropriate for the client'.

It isn't in dispute that on the basis of the information Mrs C and Mr Y gave, trading CFDs was not appropriate for them. They did not have any trading experience at all, and there's no evidence of any other investments which they held at the time.

COBS 10.3 said:

(1) If a firm considers, on the basis of the information received to enable it to assess appropriateness, that the product or service is not appropriate to the client, the firm must warn the client.
(2) This warning may be provided in a standardised format.

Guidance at COBS 10.3.3 allowed firms use their own discretion, having regard to the circumstances, when deciding whether allow consumers to open an account despite it not being appropriate.

CCC has suggested that it did provide a warning to Mrs C and Mr Y – and since they accepted the warning but wanted to go ahead anyway, it did nothing wrong. However, I'm not persuaded CCC did follow the rules above.

In reaching my findings, I've taken into account the wording in COBS 10 as well as what relevant regulators have said about how that rule should be complied with.

The European Securities and Markets Authority (ESMA) in my view clarifies how COBS 10 should be applied by firms in a document called 'Questions and Answers: relating to the provision of CFDs and other speculative products to retail investors under MiFID'.

In Section 4 'The assessment of appropriateness when offering CFDs or other speculative products to retail investors' question 2 it says:

'For example, the warning should be designed in such a way that it is an actual interruption in the process of authorising the opening of an account of entering a particular transaction. The warning should be stated in clear language, indicating that, on the basis of the answers provided, the specific product or service in question is not appropriate for the client as the client is not likely to understand the risks involved. It should also recommend clearly that the client does not proceed.'

The FCA carried out a review in 2017 and confirmed ESMA's guidance. It said that 'risk warnings should be designed to interrupt the application process'. And they should 'use clear language to communicate that a specific product or service is not appropriate for the applicant because the applicant's answers lead the firm to the view that the applicant does not have the knowledge and experience to understand the risks involved, with a clear recommendation against proceeding with the transaction'. It further said that 'when presenting a risk warning, applicants should not be asked to confirm an intention to proceed with a transaction as the next step in the application process'.

In my view, the statements above show clearly that a warning to a client following an appropriateness assessment must, at the very least, occur before the account has been opened. And in my view, the statements above also clearly show that in order for it to amount to a warning as described in COBS 10, the letter or email must clearly explain to the consumer that trading CFDs is not appropriate for them and advise them not to proceed.

In my view, sending Mrs C and Mr Y confirmation that their account had been opened, at the same time as sending them what CCC considered was a COBS 10 warning was not what the regulator intended. I'm satisfied that the purpose of the warning is to interrupt the application process and leave open the possibility of the account not being opened – otherwise the guidance at 10.3.3 would be entirely irrelevant. Furthermore the significance of warning consumers that the service isn't appropriate would be entirely diluted if the account was already opened and able to be funded.

But I'm also not at all persuaded that what CCC sent Mrs C and Mr Y amounted to the warning that the regulator intended to be sent to consumers following an appropriateness assessment. In my view it's abundantly clear that the letter CCC sent Mrs C and Mr Y was not actually warning to them not to trade CFDs. In fact it provided no such warning – the letter CCC sent to Mrs C and Mr Y simply repeated the information they had provided and attached a risk disclosure notice.

At no point did it inform Mrs C and Mr Y that based on the answers they provided, trading CFDs was not appropriate for them and they should not go ahead.

I'm satisfied that given the information Mrs C and Mr Y provided, CCC was bound to conclude that trading CFDs was not appropriate for them. And it ought to have written to them and specifically explained this – and it ought to have done this before opening their account. It ought to have encouraged them not to go ahead with the application because, in its view, they had insufficient knowledge and experience to understand the risks involved in trading CFDs.

I accept that there are circumstances when an account could still be opened despite a firm providing the warning I've mentioned above, if the consumer decided they still wanted to go ahead. In my view however, if Mrs C and Mr Y had been told not to go ahead because CFD trading was not appropriate for them, they would've chosen not to proceed with the application. I'm satisfied that their complete lack of any investment experience meant that they were reliant on CCC, as the regulated firm, providing them with the insight and the information they needed to make the decision to proceed.

I've considered whether Mrs C and Mr Y could've mitigated the losses they incurred, but I'm satisfied on balance that they had limited involvement in the trading on their account and were entirely reliant on the unregulated third parties who were trading for them. So taking this into account, I'm persuaded the losses they incurred while trading CFDs would not have been incurred but for CCC's error in the way that it handled their application and its failure to warn them not to proceed. For the reasons I've given above, this omission in my view meant that it allowed Mrs C and Mr Y to be exposed to significant risks of financial harm – risks which they did not fully understand and, given the nature of this type of trading, they had limited protection from.'

I awarded Mrs C and Mr Y compensation based on a benchmark linked to the average rate from fixed rate bonds, on the basis that they were inexperienced investors for whom capital protection was important. I also awarded £500 compensation for the distress and inconvenience they were caused.

Mrs C and Mr Y agreed with my provisional decision, but CCC didn't. It said:

- The outcome I reached was 'flawed factually' and 'mis-applies the relevant regulatory requirements'. It said that I relied on guidance which 'post-dates' the account opening. And as a result, CCC disagreed with my conclusions and the outcome.

- It highlighted the process it followed when the account was opened at the time, and asserted that it complied with the relevant regulations. It said that as a result of that assessment, it made it 'clear that the client should not trade in such products without understanding the attendant risks and it provided an additional risk warning setting out specific considerations'.

- It said that the guidance I relied on was from July 2016, but the account was opened in June 2016. It said that 'it cannot be the case that guidance that did not exist at the time of the account opening can be applied on a retrospective basis to events predating its existence'. For the same reasons it disagreed with my reliance on a review carried out by the FCA in 2017. CCC said that the firm 'must not be held to a non-existent or unexpressed standard, as the Decision does'.

- It then proceeded to outline the COBS 10.3.1R explaining that in its view the rule 'requires a firm, where it has assessed a service/product as inappropriate for a client, to provide a warning to the client'. It said that the rule did not specify a form of

wording nor a format for that warning. It said that rule allowed the firm to use a 'standardised format' and this is what it did – its process at the time was to 'employ standardised wording in the form of risk warnings sent to the client'.

- It disagreed that the warning needed to explain to the consumer that CFDs was not appropriate nor that it needed to advise them not to proceed. It said that the rule does not say that this what it needed to do. It said that the rule 'simply records that where appropriateness is not confirmed, then the client must be warned'. CCC said that this is exactly what the firm did.

- Furthermore, CCC said that I did not give sufficient consideration to the content of the Additional Risk Warning letter provided in June 2016. Nor did I give sufficient weight to the Risk Disclosure Statement which was attached. It said that given 'the context of the formulation and provision of the Risk Disclosure Statement to the client, and the reasons for it (serving as a warning as mandated by COBS 10.3.1R) this omission is a fatal flaw in the reasoning as articulated'.

- CCC then quoted parts of its Risk Disclosure Statement which said

    - You should not deal in derivatives unless you understand their nature and the extent of your exposure to risk.

    - You should also be satisfied that the product is suitable for you in light of your circumstances and financial position.

    - Although derivative instruments can be utilised for the management of investment risk, some of these products are unsuitable for many investors.

- CCC said that 'given the letter sent to the client observed his lack of experience and the unequivocal warning that he should not deal in derivatives without understanding them, the various warning observations as set out in the contemporaneous correspondence with the client and in this letter clearly fulfils the warning contemplated by COBS 10.3.1R'.

- It disagreed that there was an absence of a warning, and referred to the fact that it Additional Risk Disclosure specifically said that they 'should not deal in derivatives unless you understand their nature and the extent of your exposure to risk'. It said that this was an explicit warning. Furthermore, it said that insofar as there was 'any repetition of risk warning information communicate to clients', doing so could 'only properly be seen as a positive thing'. It did not agree that there should be a negative connotation applied to this.

- It described the risk headings in the Risk Disclosure Statement, and asserted that this complied with COBS 10.3.1R. It said that I had also not given proper consideration to the alternative options which it suggested to the consumers, such as opening a demo account, seeking advice or appointing an attorney.

- It asserted that it was wrong to use guidance which post-dated the account opening, and asserted that the warnings and suggestions of alternatives to opening the account 'interrupted the process and ensured that the client could only proceed in the knowledge that an account and CFD trading should only occur if the client had a full understanding of the risks involved'.

- It disagreed with my conclusion that Mrs C and Mr Y had limited involvement in the trading on their account and were instead reliant on unregulated third parties trading

for them.

- And in any event, it said that using attorneys was a matter for them and not something which CCC was involved in. In addition, the LPOA agreement which signed confirmed that the clients were responsible for the assessment and appointment of their LPOAs as well as for monitoring their activities.

- It concluded by asserting that it did not accept any compensation was payable to the consumers. And it confirmed that it in its view, it provided 'ample and significant explicit warnings to the client, all of which were in compliance and satisfaction of the requirements as set out in COBS 10.3'. It disagreed that trading losses made by the clients were incurred in consequence of anything it did wrong. It said that the approach I had taken was fundamentally flawed and the correct approach was the conclusion the investigator had reached.

What I've decided – and why

I've considered all the available evidence and arguments to decide what's fair and reasonable in the circumstances of this complaint.

CCC has provided detailed comments. I understand it profoundly disagrees with my provisional decision. I've reviewed the comments it has provided very carefully. However, the purpose of this decision isn't to address every point it has raised, and so I hope it doesn't take it as a discourtesy that I've not done that here. Instead I've focused on what I consider the main point of disagreement – whether what it considers was a 'warning' pursuant to COBS 10.3 met the requirement of that rule.

Before I do address CCC's comments, it's important that I explain why I've relied on information from ESMA and the FCA which, as CCC has pointed out, postdates the opening of the account. Whilst I note CCC's objections to me using this information, I'm not persuaded its objections have merit. I've not applied a rule or official guidance that fundamentally changed or altered the existing requirements as they are set out in COBS 10.3. I haven't retrospectively applied a standard which was not applicable at the time Mrs Y and Mr C opened the accounts – I agree that would be unfair. Instead the information from ESMA and the FCA that I've relied on highlights both regulators expectations as to how firms ought to be complying with the rules that were already in place at the time Mrs Y and Mr C opened their account. I don't agree that what ESMA or the FCA have said at the time was 'new' in the sense that it can't be applied retrospectively – in my view, ESMA and the FCA were in fact explaining how they expected firms to already be applying the relevant rules, and highlighting examples of bad practice.

Therefore, whilst I appreciate why CCC disagrees, in my view the ESMA Q&A and FCA review I quoted are entirely relevant to this case and what CCC did – they also clearly contradict CCC's main reasons for believing that it complied with COBS at the time.

One fundamental area where I disagree with CCC is the nature of the warning that COBS 10.3.1 required. I don't agree that merely highlighting to a consumer that they shouldn't go ahead unless they understood the risks is the type of warning which is envisaged here.

In my view, the wording of the rule is clear that what the client needs to be warned about is the firm's conclusion that the service or product is not appropriate. This is the whole point of requiring firms to specifically assess appropriateness. And in my view the wording of COBS 10.3.1 is unequivocal in that regard:

'If a firm considers, on the basis of the information received to enable it to assess

appropriateness, that the product or service is not appropriate to the client, the firm must warn the client.'

It's clear to me that what's required is for the firm to 'warn the client' that 'it considers, on the basis of the information received to enable it to assess appropriateness, that the product or service is not appropriate'. I don't agree a warning which doesn't specifically make this clear is sufficient. I accept that this could be in a standardised format – but the fundamental nature of the warning ought to be as I've set out above. The reason I say this is because other rules in COBS already mandate the types of 'standard' risk warnings which firms ought to be sending to all their customers. I'm satisfied that the intent behind COBS 10.3.1 is not for a warning about the product or its risks to be sent, as the firm ought to have already sent that information. To my mind the warning must convey to that consumer the outcome of the firm's assessment that the product is not appropriate – no other interpretation makes sense when viewing a firm's obligations as a whole.

Further, in my view the purpose of the appropriateness assessment is to establish which clients *should not be buying the investment or service because they do not have sufficient knowledge and experience to understand the risks involved.* And the warning must, in my view, clearly warn the client that the assessment the firm has carried out means it is not satisfied that the client understands the risks. A warning which does not set out the outcome of the appropriateness assessment in my view would entirely defeat the purpose of COBS 10, and the risk of consumer detriment which it is quite clearly trying to address.

And so for the same reasons, I'm not persuaded by CCC's comments about my consideration of the additional risk warning and disclosure. I took those documents very carefully into account before provisionally concluding that they did not amount to a 'warning' as provided for in COBS 10. Despite the references which CCC has outlined, nothing in those documents, in my view, addresses the fundamental flaw in CCC's process. CCC had already established that Mrs C and Mr Y *did not have sufficient knowledge and experience to understand the risks involve*. At no point did it actually tell Mrs C and Mr Y this. It left it to them to decide whether they had such knowledge - even though CCC already knew they did not. This is not the warning that needed to be sent following a failed appropriateness assessment. For the reasons I've given above, I'm satisfied that warning needed to specifically reference the fact that trading CFDs was not appropriate because Mrs C and Mr Y lacked the experience and knowledge to understand the risks involved.

Whilst I note that CCC disagrees with those conclusions, what it has said about the nature of the warning and why it considers it complied with COBS 10 is also directly contradicted by what ESMA and the FCA have both said about what information the warning should include and what it should say.

As I said in my provisional decision, ESMA explained in their questions and answers that:

'The warning should be stated in clear language, indicating that, on the basis of the answers provided, the specific product or service in question is not appropriate for the client as the client is not likely to understand the risks involved. It should also recommend clearly that the client does not proceed.'

And the FCA echoed this interpretation in 2017 when it said that warnings should *'use clear language to communicate that a specific product or service is not appropriate for the applicant because the applicant's answers lead the firm to the view that the applicant does not have the knowledge and experience to understand the risks involved, with a clear recommendation against proceeding with the transaction'.*

I find what both regulators have said about the warning persuasive evidence that CCC did not adhere to the rule. None of the information CCC sent Mrs C and Mr Y warned them that trading CFDs was not appropriate for them. At no point did CCC explain, in clear language, that their total lack of any investment experience meant that trading CFDs was not appropriate – and at no point did CCC provide a 'clear recommendation against proceeding'.

So for these reasons, I remain satisfied that based on the information that Mrs C and Mr Y provided, CCC was bound to conclude that trading CFDs was not appropriate for them – and it ought to have warned them of that fact and encouraged them not to proceed. CCC didn't do this, and as a result, I'm satisfied it didn't treat them fairly.

And for the reasons I gave in my provisional decision, and which I now confirm as final, I'm satisfied that if Mrs C and Mr Y had been told by the very firm they were looking to open an account with, that trading CFDs was not appropriate for them, they would've chosen not to proceed. I say this because I'm satisfied that their complete lack of any investment experience meant that they were reliant on CCC, as the regulated firm, providing them with the insight and the information they needed to make the decision to proceed.

I've reconsidered whether Mrs C and Mr Y could've mitigated the losses they incurred, but I'm satisfied on balance that they had limited involvement in the trading on their account and were entirely reliant on the unregulated third parties who were trading for them. So taking this into account, I'm persuaded the losses they incurred while trading CFDs would not have been incurred but for CCC's error in the way that it handled their application and its failure to warn them not to proceed – because, as I've said, they would not have opened this account, and therefore incurred such losses, had they been properly warned.

For the reasons I've given above, this omission in my view meant that it allowed Mrs C and Mr Y to be exposed to significant risks of financial harm – risks which they had insufficient knowledge and experience to understand and, given the nature of this type of trading, they had limited protection from.

Putting things right

In assessing what would be fair compensation, I consider that my aim should be to put Mrs C and Mr Y as close to the position they would probably now be in if they had not been given unsuitable advice.

I take the view that Mrs C and Mr Y would have invested differently. It is not possible to say *precisely* what they would have done differently. But I am satisfied that what I have set out below is fair and reasonable given Mrs C and Mr Y's circumstances and objectives when they invested.

What must CCC do?

To compensate Mrs C and Mr Y fairly, CCC must:

- Compare the performance of Mrs C and Mr Y's investment with that of the

benchmark shown below and pay the difference between the *fair value* and the *actual value* of the investments. If the *actual value* is greater than the *fair value*, no compensation is payable.

- CCC should also pay interest as set out below.

- Pay to Mrs C and Mr Y £500 for the distress and inconvenience caused by CCC allowing them to take such a significant risk with their money.

Income tax may be payable on any interest awarded.

Portfolio name	Status	Benchmark	From ("start date")	To ("end date")	Additional interest
CFD trading account	No longer in force	Average rate from fixed rate bonds	Date of investment	Date ceased to be held	8% simple per year on any loss from the end date to the date of settlement

Actual value

This means the actual amount paid from the investment at the end date.

Fair value

This is what the investment would have been worth at the end date had it produced a return using the benchmark. To arrive at the *fair value* when using the fixed rate bonds as the benchmark, CCC should use the monthly average rate for one-year fixed-rate bonds as published by the Bank of England. The rate for each month is that shown as at the end of the previous month. Those rates should be applied to the investment on an annually compounded basis.

Any additional sum paid into the investment should be added to the *fair value* calculation from the point in time when it was actually paid in. Any withdrawal from the CCC should be deducted from the fair value calculation at the point it was actually paid so it ceases to accrue any return in the calculation from that point on. If there is a large number of regular payments, to keep calculations simpler, I'll accept if CCC totals all those payments and deducts that figure at the end to determine the fair value instead of deducting periodically.

Why is this remedy suitable?

I've decided on this method of compensation because Mrs C and Mr Y wanted to achieve a reasonable return without risking any of their capital. The average rate for fixed rate bonds would be a fair measure given Mrs C and Mr Y's circumstances and objectives. It doesn't mean Mrs C and Mr Y would've invested only in a fixed rate bond. It's the sort of investment return a consumer could've obtained with little risk to their capital.

My final decision

I uphold the complaint. My decision is that City Credit Capital (UK) Ltd should pay the amount calculated as set out above.

City Credit Capital (UK) Ltd should provide details of its calculation to Mrs C and Mr Y in a clear, simple format.

Under the rules of the Financial Ombudsman Service, I'm required to ask Mrs C and Mr Y to accept or reject my decision before 19 December 2022.
Alessandro Pulzone
Ombudsman