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## Pivotal UK Supreme Court Ruling on the Protection of Client Monies

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**The Lehman Brothers International (Europe) (In Administration) ("LBIE") client money litigation has generated significant interest. It deals with fundamental issues concerning the protections given by financial institutions to their clients. The decisions of the High Court and Court of Appeal on LBIE were keenly followed by the market.<sup>1</sup> Certain key points were appealed to the UK's highest court, the Supreme Court (previously the House of Lords), which handed down its judgment this week.<sup>2</sup> The case is of great interest not only for the Lehman creditors but also for those with interests in the MF Global administration, and more generally for customers who are concerned about assets that they place with financial institutions.**

### What did the Supreme Court ruling address?

The Supreme Court ruled on the following three issues:

- When does the statutory trust in relation to client money arise – upon receipt by a firm or when the firm segregates it?
- Do the client money distribution rules apply to all identifiable client money, including client money held in house accounts?
- Is participation in the notional client money pool ("CMP") dependent on actual segregation of client money, or do clients for whom client money was not segregated, but who were entitled to have it segregated, share in the CMP?

<sup>1</sup> If you wish to review further information on these cases, you may refer to our client publications

1) "Lehman Brothers International Europe – Unravelling the complexity of client money claims" available at <http://www.shearman.com/files/Publication/648a4f11-a3f0-43cc-9f2f-5cb3a4492829/Presentation/PublicationAttachment/380ff0dd-fa08-4f0f-a160-59c6c66d021a/AM-052009-Lehman-Brothers-International-Europe-Unravelling-the-Complexity-of-CI.pdf> and

2) "What's Broken with the UK's Client Asset and Money Protections and How to Fix It" available at <http://www.shearman.com/whats-broken-with-the-uks-client-asset-and-money-protections-and-how-to-fix-it-11-03-2010/>

<sup>2</sup> [http://www.supremecourt.gov.uk/decided-cases/docs/UKSC\\_2010\\_0194\\_Judgment.pdf](http://www.supremecourt.gov.uk/decided-cases/docs/UKSC_2010_0194_Judgment.pdf)

The Supreme Court dismissed the appeal on each of the three issues and held as follows:

## A statutory trust arises on receipt of client money (unanimous)

- The Court unanimously held that the statutory trust in relation to client money arises when the firm receives client money. The Court rejected the argument that the trust only arises once the firm has segregated client money. The Court's solution was regarded as achieving the objectives of both the Markets in Financial Instruments Directive<sup>3</sup> ("MiFID") and the FSA's client money rules contained in CASS 7 of the FSA Rulebook. CASS 7 contains the rules for firms handling client money. A key obligation is for MiFID firms to segregate money that they receive in the course of MiFID business from the firm's own money. Most significant firms will be MiFID firms conducting MiFID business. The ruling that the statutory trust applies to client monies on receipt, regardless of whether they have been segregated, is significant as the scope of assets potentially within the CMP and available to protected customers is broader than it would be if only segregated assets were included.

## The primary pooling arrangements were held to apply to client money in house accounts (with Lords Hope and Walker dissenting in part on this point)

- The majority held that CASS 7.9.6 is to be read as requiring all identifiable client money to be treated as pooled whether or not such money was held in a segregated client bank account or a house account. If only segregated client money was to be pooled, clients would have to rely on the firm to comply with its regulatory obligation to segregate client money in order to be afforded the full extent of the protection envisaged by MiFID. This outcome is unfavourable to clients dealing with firms that have inadequate systems or otherwise have failed in their duties to segregate client monies. However, clients whose assets were actually segregated argue that having carried out diligence to ensure that their assets were segregated, they merit greater protection than those who failed to carry out the same checks. As a result of this judgment, the client money pool will be shared between all claimants, whether purportedly diligent or not, resulting in reduced claims for the segregated clients.

## Participation in the CMP was held not to depend on the segregation of client money (with Lords Hope and Walker dissenting)

- The majority upheld the 'claims basis' for participation in the CMP. Accordingly, those clients of the investment firm with an entitlement (contractual or otherwise) to have client money segregated for them will have a beneficial interest in the CMP. The Court rejected the argument that only those clients for whom the firm had actually segregated client money in client bank accounts were entitled to participate in the CMP. The client money rules are intended to protect all client money received prior to a primary pooling event ("PPE") (in this context when LBIE entered into administration). This was deemed to be consistent with the clear purpose of CASS 7, which is to grant a high degree of protection to client monies.

<sup>3</sup> Markets in Financial Instruments Directive 2004/39/EC

## What are the implications of this ruling?

- Lord Dyson, giving the leading judgment for the majority, accepted that the decision provides for a "cataclysmic shift of beneficial ownership" in the context of LBIE's administration. It seems certain that the immediately identifiable CMP is subject to a significant shortfall. Briggs J had noted in his judgment in the High Court that "LBIE failed to identify as client money, and therefore also failed to segregate, vast sums received from or on behalf of a significant number of its clients. In this respect, the most significant group of clients whose money LBIE failed to segregate were its own affiliates ... Thus, even if there were no claims at all by clients whose client money LBIE failed to segregate, there exists a real risk that the shortfall on the client account will exceed 40% due to the Bankhaus failure [alone]."
- The Supreme Court's ruling clearly takes a broad approach both to the scope of client money and to the number of persons interested in the pool, with the outcome that unsecured creditors will claim against a diminished estate. Interestingly, the Court applied a purposive approach to the interpretation of CASS, not least because of the ambiguities and lack of clarity in relevant CASS provisions. The result is that clients with claims for segregated client money and clients with claims for non-segregated client money are in principle to be treated equally. If a firm fails to segregate the client money it receives, this will not result in any differential treatment in terms of proprietary rights for clients with client money claims.
- The difficulty is that, for accounts other than the firm's client bank accounts and the house account used to take in client money, clients will need to rely on complex tracing procedures to identify assets or monies that may be brought within the CMP. This is the particular challenge in the tracing application made by the Joint Administrators of LBIE which was adjourned by the High Court on 11 May 2011 pending the Supreme Court's ruling on the above client money issues. LBIE's administrators will most likely require detailed guidance from the High Court in relation to the appropriate tracing procedures. They have issued an update on the judgment, stating: "[i]f further assistance from the Court is required, the Supreme Court has held that such further guidance must be sought from Mr Justice Briggs, as the judge overseeing LBIE's administration".<sup>4</sup> There is now likely to be further litigation on the extent to which monies held in a house account can be traced and included in the client money pool. As to the timing of any distributions of client monies, Lord Walker comments: "[a]s to the need for the administrators to have a workable scheme which provides for a timely distribution, that is an aspiration which has already, sadly, perished. A straightforward, timely distribution is impossible because of LBIE's massive non-compliance with CASS 7." Tony Lomas, joint administrator of LBIE, has confirmed that any distributions will be delayed. Similar issues may arise in connection with the more recent MF Global UK Limited administration. Going forward, it is likely that clients will still want to ensure proper segregation of their monies to avoid having to rely on tracing procedures as a basis for a proprietary claim. More generally, the FSA will most likely introduce significant revisions to the CASS rules in light of this judgment.

<sup>4</sup> For further information, please follow this link <http://www.pwc.co.uk/business-recovery/administrations/lehman/lehman-client-money-update-29022012.jhtml>

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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