SHEARMAN & STERLING LLP

FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY | CLIENT PUBLICATION

19 February 2013

The "Hindsight" Principle Does Not Apply to Client Money Claims in UK Broker Insolvencies

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Contacts

Barnabas W.B. Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

Thomas Donegan
London
+44.20.7655.5566
thomas.donegan@shearman.com

Jo Rickard
London
+44.20.7655.5781
josanne.rickard@shearman.com

Patrick Clancy
London
+44.20.7655.5878
patrick.clancy@shearman.com

Ian Harvey-Samuel
London
+44.20.7655.5000
ian.harvey-samuel@shearman.com

James Duncan
London
+44.20.7655.5757
james.duncan@shearman.com

Fredric Sosnick
New York
+1.212.848.8571
fsosnick@shearman.com

Solomon J. Noh
London
+44.20.7655.5795
solomon.noh@shearman.com

The High Court in London has held that clients of insolvent UK brokers are entitled to a claim based on the value of their open positions as at the date of entry into administration or liquidation, rather than based on the value actually realised when those positions are closed. The "hindsight" principle – that where assets are later actually valued, actual values should be used – is not applicable.

Background

Under the client money and client asset rules contained in the CASS 7 and 7A sourcebooks of the UK Financial Services Authority (the "**FSA**") Handbook (the "**client money rules**"), brokers are required to segregate money received from or held for their clients and will hold such funds pursuant to a statutory trust. In the event of the broker entering administration or liquidation, client money is segregated from the broker's property and is distributed to clients on a *pari passu* basis (meaning "*pro rata*").

The client money rules have been the subject of protracted litigation and judicial criticism in various cases due to their lack of clarity and even drafting errors. A number of issues regarding the client money rules were resolved by the UK Supreme Court in February 2012 in the litigation arising out of the Lehman insolvency, and have been discussed in a previous client publication.[1] The client money rules have also been amended in various ways and are currently subject to a consultation process for more wholesale amendment.[2]

On 31 October 2011, investment broker MF Global UK Limited became the first investment company to enter the special administration regime under the Investment Bank Special Administration Regulations 2011. It held client money as well as many open derivative positions for clients.

An application to the High Court was made by MF Global UK Limited's administrators for directions as to the appropriate basis of valuation of client positions in derivatives for the purpose of distributing client money under the client money rules.

1 See http://www.shearman.com/pivotal-uk-supreme-court-ruling-on-the-protection-of-client-monies-03-02-2012/.

2 See the FSA Consultation Paper "Client assets regime: EMIR, multiple pools and the wider review" at http://www.fsa.gov.uk/static/pubs/cp/cp12-22.pdf and the FSA Policy Statement "Client assets regime: changes following EMIR" at http://www.fsa.gov.uk/static/pubs/policy/ps12-23.pdf.

Contacts (cont.)

Azad Ali
London
+44.20.7655.5659
azad.ali@shearman.com

Aatif Ahmad
London
+44.20.7655.5120
aatif.ahmad@shearman.com

Mark Dawson
London
+44 20 7655 5609
thomas.donegan@shearman.com

Anna Doyle
London
+44.20.7655.5978
anna.doyle@shearman.com

Mak Judge
London
+44.20.7655.5182
mak.judge@shearman.com

Simon Jerrum
London
+44.20.7655.5727
simon.jerrum@shearman.com

Ellerina Teo
London
+44.20.7655.5070
ellerina.teo@shearman.com

Issue

The High Court considered whether, in calculating a client's entitlement under the client money rules, the client's positions on trades brokered by the firm should be valued by reference to: (i) market values as at the primary pooling event (the "**PPE**"), in this case the date the broker entered into special administration; or (ii) the prices at which the trades were subsequently closed-out – i.e. the prices at which the contracts were actually sold when they were liquidated, which is commensurate with the "hindsight" principle.

Decision

Mr. Justice David Richards was the presiding judge, as in other MF Global cases.[3] He noted that, under CASS 7A.2.4R(2), the distribution of pooled client money must be made "rateably" in accordance with each client's "client money entitlement", calculated in accordance with CASS 7A.2.5R. However, the term "client money entitlement" is not defined in the FSA Handbook. As such, one of the arguments in favour of the "hindsight" principle was that this 'gap' in the rules should be 'filled' by the "hindsight" principle, which was argued to be a fair and sensible means of calculating the amount to be distributed to each client. In the *Lehman*[4] decision, at first instance, Mr. Justice Briggs held that claims were valued at the point of insolvency. However, many practitioners considered this to be illogical, given that dealers and clearing houses would close out actual contracts referable to actual customers and actual prices after the point of insolvency, which should more logically be used.[5]

Mr. Justice David Richards rejected the applicability of the "hindsight" principle, holding that there is no gap in the client money rules that is required to be filled. He instead considered that the FSA had adopted a "notional close-out prices" basis for valuing client positions. This is the same basis as that applied for daily reconciliations under the client money rules and follows Mr. Justice Briggs' decision in Lehman, as well as Mr. Justice David Richards' own decision in the *Global Trader*[6] case. It was noted that notional close-out prices produce consistency, both with the daily reconciliation regime and across claims as at the PPE date, and may assist in a timely distribution of client money. The judge considered that the use of the notional close-out prices basis makes sense from an FSA policy perspective for the purposes of consistency, simplicity and speed.

It remains to be seen if the case will be appealed.

Upcoming Reforms

As mentioned above, there are currently proposals from the FSA to subject the client money rules to wholesale reform.[7] The reforms are required in part to ensure the client money

[3] See our client publication on the joinder of clearing houses to other MF Global proceedings at http://www.shearman.com/Clearing-Houses-Joined-as-Parties-in-MF-Global-Dispute-at-the-High-Court-in-London-11-21-2012/.

[4] *Lehman Brothers International (Europe) in administration v CRC Credit Fund Ltd & Ors* [2009] EWHC 3228 (Ch).

[5] See our client publication on the Lehman case at first instance at http://www.shearman.com/more-lessons-from-lehman-protecting-client-assets-12-23-2009/.

[6] *Re Global Trader Europe Ltd (In Liquidation)* [2009] EWHC 602 (Ch).

[7] See the FSA Consultation Paper and Policy Statement at fn. 2, above.

rules are compliant with the European Market Infrastructure Regulation[8] (the "**EMIR**"), which entered into force in the EU on 16 August 2012, but are also part of the FSA's intention to generally review this area.

EMIR requires members of clearing houses to offer clients either: (i) individual segregated accounts (in which a client's positions or margin is held in a separate account at the clearing house from other clients of a clearing member); or (ii) omnibus segregated accounts (in which the positions and margin of a number of the clearing member's clients are recorded in the same account at the clearing house).

EMIR also introduces a requirement for clearing houses to "port" (i.e. transfer or novate) client positions and associated margin on clearing member default to another solvent clearing member. When this is not possible, under EMIR the clearing house must close out the positions and return the margin and any remaining balance to the client. The current client money rules are not compatible with this requirement, as they currently provide that available funds must be shared *pro rata* amongst the defaulting clearing member's clients.

Under the proposed amended client money rules, if a clearing house closes out or ports contracts or margin, this would be outside the client money trust (with the consequence that any margin would never be subject to pooling). It follows that under the proposed reforms to the client money rules being considered by the FSA, there will be fewer scenarios in which this judgment will be relevant. In addition, in the case of an individual segregated account on close-out, the issue considered in the judgment is also academic because only a single client would be interested in the pool.

The judgment will largely be relevant under the amended client money rules only to omnibus accounts and positions which are not ported by a clearing house. In such situations, client money beneficiaries will continue to share in one another's losses and gains, regardless of the position to which the loss or gain relates.

[8] Regulation (EU) No 648/2012.

BROADGATE WEST | 9 APPOLD STREET | LONDON | EC2A 2AP