SHEARMAN & STERLING LLP

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Holding financial assets with UK financial institutions: lessons from Lehman, Global Trader and the financial crisis

Many persons hold assets with financial institutions in the UK. Such holdings can be direct and also indirect. Providers based outside the UK, including in the United States, often place client assets with entities in the UK. The UK legal regime is generally very robust and attractive to investors. However, methods of holding assets with UK financial institutions have recently come under scrutiny in light of the Lehman insolvency and the financial crisis. Persons with proprietary claims over assets may not be able to recover their assets until an insolvency practitioner is satisfied they fall outside the insolvent estate - which may take some time. In addition, certain persons have found that they have no proprietary rights due to compliance and systems failures by the institutions they thought were holding their assets. This note considers the risks that arise in connection with the holding of financial assets and possible mitigating steps that can be taken to reduce those risks.

The financial crisis has resulted in a series of governmental initiatives to ensure that we are better placed to cope should such events happen again. It seems inevitable that there will be enhanced compliance requirements applicable to financial institutions that hold assets for third parties. At least in the short term, there will also be greater regulatory attention to client asset segregation.

Regardless of the outcome of regulatory initiatives, there are various practical steps that users of financial services can take to protect their assets and that financial institutions can take to give assurances to their clients. This publication considers some of the specific shortcomings in certain UK client asset structures that have been exposed by the financial crisis and possible solutions or mitigating steps. It should always be borne in mind that enhanced protections and more complex systems for protecting client assets are often likely to be more costly than less complex procedures involving reduced protections.

The following particular issues are discussed:

- ***Co-mingling*** by financial institutions of client assets with the institution's own assets can result in exposure to risk of the institution's insolvency. Clients may wish to monitor records relating to client assets to ensure that assets are not co-mingled.
- The applicability of ***rights of rehypothecation*** and security to client trust accounts should be considered. Separate custody accounts and security accounts may be advantageous.
- Clients should ***scrutinise documentation*** relating to client accounts to ensure that required trusts are perfected through properly executed, accurate documentation.
- Clients should consider restricting the use of ***sub-custodians***. Direct relationships with custodians or depositories in other jurisdictions may provide more robust arrangements in an insolvency.

- Proprietary assets are likely to take some time to be returned to clients. The use of ***third party trustees*** to hold assets may mitigate such delays (but bring additional cost).
- Agreements should provide for ***events of default*** and rights of close-out and set-off for clients as well as institutions.
- Clients and financial institutions should consider introducing contractual ***limits on rehypothecation***.
- Clients would be well advised to encourage financial institutions to make arrangements for the settlement of transactions and holding of collateral through ***clearing houses***, not "over the counter", where possible.
- Clients should ensure that their ***client categorisation*** or "opt outs" do not preclude the benefits of client asset treatments.
- Clients should consider imposing limits on financial institutions using ***affiliates as bankers*** or custodians of assets.

Background: UK client asset rules and insolvency law

Rights relating to client assets belong beneficially to the clients of a financial institution but the assets themselves are held by the financial institution on trust. Such assets in principle should not be available to creditors of a financial institution following an insolvency.

Financial institutions which are regulated by the Financial Services Authority ("FSA") must comply with various requirements in relation to client assets. Different rules apply for cash and non-cash assets.

In relation to cash, financial institutions must place client money in segregated bank accounts. Generally, the account must be with a third party bank and must not be an account into which any of the institution's own cash is deposited. Financial institutions are subject to record-keeping requirements and investment restrictions in relation to account moneys. Pursuant to a "statutory trust", the financial institution's receivable in relation to the bank account is held on trust for the institution's clients. In order to perfect the trust, financial institutions must procure that the bank acknowledges the account is a trust account and waive its set-off rights.

There are two methods of complying with the client asset rules in relation to cash. The "normal approach" involves actual segregation of cash received from clients. The "alternative approach" allows financial institutions to set aside an amount equivalent to client moneys in an account, labelled a client money account, with regular reconciliations.

For non-cash assets, financial institutions must make adequate arrangements to safeguard their clients' ownership rights, including in the event of insolvency, most obviously by way of establishing a trust over client assets. There are record-keeping requirements including that custody accounts for non-cash client assets are appropriately labelled.

If a financial institution becomes insolvent and a client asset trust has been properly established, the clients will have a proprietary claim over non-cash assets. The clients will also have a proprietary right over any amount received by the financial institution from a bank at which the financial institution held an account containing client money. In effect, the clients would be able to claim that the relevant assets belong to them and fall outside the financial institution's insolvent estate. Where this is the case, the clients are entitled to full recovery of the relevant assets, subject only to a deduction for payment of the insolvency practitioner's costs properly attributable to the distribution of the client assets. In contrast, if relevant assets are not subject to a trust, the client is an unsecured creditor and would be entitled only to a share of any assets of the insolvent financial institution after all secured creditors and the costs of the insolvency have been paid for. In reality, unsecured creditors rarely receive more than a few pennies in the pound for any amounts owed following an insolvency caused by financial difficulties.

Various arrangements under which assets are transferred to a financial institution will not result in a client asset trust. Assets provided by way of title transfer collateral do not constitute trust assets. In addition, professional clients may opt out of client asset segregation by consent. Finally, any exercise by a financial institution of rights of rehypothecation (i.e. to use the assets) will result in such assets ceasing to be client assets.

Statutory trusts and the co-mingling of assets

Difficulties: A trust in relation to a client assets, or over an account at which client moneys are deposited, may not exist, or trust assets may not be traceable, if the financial institution has failed to segregate accounts correctly. In the *Global Trader*[1] case, the financial institution (apparently honestly) failed to categorise its clients appropriately, keep good records or identify properly which of the assets in its possession were client assets. The financial institution transferred cash that should have been client cash to the firm's general accounts and combined transactions in client assets with transactions for the institution's own account. It was held that assets must remain identifiable and be traceable in order for a proprietary claim over client assets to succeed. On the facts, due to co-mingling, client assets subject to a trust were not identifiable. The Court considered that an "attempt to establish a tracing case will be difficult".

Solutions and mitigating steps: In principle, if a financial institution has sound records, systems and procedures, the issues exposed by *Global Trader* should not arise. Users of financial services should be careful about whom they place assets or deposit client moneys with. Regular due diligence could be carried out on the financial institution, its systems and documentation. An alternative would be to use a bespoke third party trustee as the legal owner of client assets. The third party could be either a special purpose group company related to the financial institution or independent. Such structures would involve additional operational complexity and would have to be paid for. It must also be borne in mind that the groups which control trust companies or custodians may also become insolvent and remove group funding from such entities. As a result, insolvency risks cannot be fully mitigated under this approach.

Separately, in practice, client assets are often pooled. Where this takes place, a client would at best share the beneficial interest in the pooled account and will share in any shortfall together with the other clients whose assets are pooled. Clients should request information about whether pooling of client assets occurs. Where pooling does take place, clients should consider requesting financial institutions to pool the assets of only clients holding investments of a particular type in a particular segregated account so as to reduce the risks of losses on risky assets impacting other clients. Alternatively, they could insist (at a cost) in having a fully segregated account, not pooled with other customers.

Various standard form agreements of financial intermediaries, such as trustees and prime brokers, seek to exclude fiduciary and trustee relationships. Such provisions may be inconsistent with the terms of the trust over client non-cash assets, the statutory trust over client money accounts and with generally accepted structures for many businesses. Such provisions should be included only in instances where they reflect the reality.

Rehypothecation, liens and security interests

Difficulties: Rights of rehypothecation (or use) are contained in many agreements with financial institutions such as 'clearing member' service providers and prime brokers. Pursuant to rehypothecation provisions, a financial institution is able to take assets deposited by its client and use them in the financial markets as security against liabilities of the client to the financial institution arising as a result of transactions the institution enters into for its client. Upon, and to the extent of, rehypothecation, a client ceases to have any beneficial interest in relation to the assets. A rehypothecation right in favour of a financial institution over an asset or account will not of itself preclude the account or asset from being subject to a trust if the assets are segregated. However, rehypothecation rights together with a lack of segregation in practice are likely to make any proprietary claim difficult to establish. Pursuant to a lien, a financial institution may be able to retain possession of assets or cash until all outstanding claims (e.g. for payment of fees) are satisfied. Security

[1] *Re Global Trader Europe Ltd (in liquidation)* [2009] EWHC 602 (Ch).

interests will enable a financial institution to apply any assets in its possession against any liabilities owed to it by the client.

Solutions and mitigating steps: Clients may wish to consider requesting financial intermediaries with rehypothecation rights to run two accounts. The first account would be a custody account, subject to the client asset rules and with no rights of rehypothecation or security available to the financial intermediary but perhaps with a lien for fees. The second account, a security account, could be used for transactions and assets would be held as security against the liabilities of the client to the institution. The financial institution would be given rights to transfer assets from the custody account to the security account for the purposes of making cash available as collateral (to the extent this is required) and potentially could have rights of rehypothecation over the assets in the security account. However, the financial institution should be required to return assets which do not secure obligations immediately to the custody account. It may be helpful to clarify in relevant agreements that assets returned to the custody account become subject to the client asset trust upon such re-transfer. There may be some cost consequences of establishing or amending arrangements of this nature.

Record-keeping issues

Difficulties: In *Global Trader*, the financial institution had failed to comply with the client asset rules due to failures in documentation and business processes. Lehman similarly appears to have kept poor records concerning client assets and many records were lost or ceased to become available upon its insolvency. For example, some of Lehman's back office third-party service providers terminated their agreements upon the administration commencing and many employees left. Also, in the case of Lehman, some of the acknowledgements of trust and waivers of set-off that financial institutions must obtain from banks in relation to client money accounts were either not obtained or not executed properly. Following a review, the FSA issued a letter during March 2009 to firms that accept client money. The FSA noted that, in many cases, acknowledgement of trust and waiver of set off letters are incompletely or inaccurately executed (e.g. wrong legal name for the institution), are not signed by authorised signatories, do not identify affected accounts with sufficient certainty or simply do not exist. In the absence of waivers of set-off being properly executed, banks where client money is deposited may seek to exercise set-off rights against the financial institution.

Solutions and mitigating steps: Various practical steps can be taken by clients to ensure that trust arrangements are robust. Records of accounts at third-party financial institutions into which assets are transferred could be checked. Such accounts should be labelled in the account name as "client account" or "client trust account". In addition, clients may consider carrying out due diligence on acknowledgements of trust and waivers of set off. Such documents should specifically identify the accounts in question, preferably by name and account number, and should be signed by authorised signatories of the institutions with the correct legal names of all parties included. Clients could request regular reporting and account statements to ensure that moneys and assets are credited to the correct accounts and are properly segregated.

Specific contractual obligations on firms to facilitate due diligence (in addition to obligations simply to comply with applicable laws) and possibly client audit rights should be considered. Financial institutions may request additional fees to comply with such provisions. Clients are likely to be particularly interested in (i) the value of assets that are trust assets; (ii) what assets are held; (iii) which banks, custodians and sub-custodians are used; (iv) in which jurisdictions any accounts, custodians and sub-custodians are located; (v) relevant account numbers; (vi) whether the assets in accounts are pooled with assets of other customers or with the institution's own assets; (viii) what sorts of businesses other pooled clients engage in and what sort of investments they hold; and(viii) what rights of lien, set-off, rehypothecation and security exist.

Proposed regulatory developments would result in records relating to client assets being produced in a regularly updated "business information pack". These packs would be available for regulators to pass on to insolvency practitioners so as to speed up insolvency processes.

Cross-border insolvencies and exposure to other legal regimes

Difficulties: Any co-mingling of client assets complicates proprietary claims. Co-mingling and difficulties with proving ownership in an insolvency are exacerbated when assets are held through chains of intermediaries, particularly if any of the intermediaries are in an insolvent group or assets are pooled. For successful recovery on an insolvency, clients' claims against the financial institution will ultimately need to be enforceable in the jurisdiction where assets are held. Custodians will often use sub-custodians in other countries, which themselves may pool assets with those of persons who are unconnected to the client or its custodian. Furthermore, assets may be held in jurisdictions where trusts are not recognised or relevant assets may be regarded as part of the estate of the insolvent sub-custodian. Finally, financial institutions often exclude liability for sub-custodians. These factors may make claims in relation to client assets difficult to assess and delay a successful claim.

Solutions and mitigating steps: Clients should consider restricting the use of sub-custodians or other downstream financial intermediaries. Sub-custodian liability provisions should be considered carefully. The establishment of direct relationships with custodians or depositories in jurisdictions where clients have investments would likely simplify any claims on an insolvency, although this would involve an additional compliance burden. Custodian liability for sub-custodians may be linked to higher fees.

Delays in claims on an insolvency

Difficulties: Insolvency practitioners may take time to return assets in the possession of an insolvent company. This is particularly an issue for assets held as security, given that an insolvency practitioner will want to be sure that the security cannot be applied before making a distribution. The duty of insolvency practitioners is primarily to creditors, not to the owners of assets not forming part of the company's estate. Insolvency practitioners are likely only to return assets if they have a so-called "high degree of confidence" that such assets should not be available to creditors. In the case of *RAB Capital*,[2] it was held that if the administrator fails to deal with a case as expeditiously as a client might wish but still acts in accordance with its duties, the Courts will not intervene. Governmental (in)action in relation to Lehman client money indicates a willingness on the part of regulators only to interfere with the timing of payments when the release of the amounts involved is systemically important.

Solutions and mitigating steps: Not all clients have been subject to delays in the Lehman administration: £12.2 billion (46%) of client assets had been returned by the administrators of Lehman by 14 March 2009. Claims in relation to custody accounts where the relationships have been properly documented can usually be dealt with expeditiously by an administrator. Exercise of set-off rights on an insolvency (discussed below) may enable clients to realise much of the value of their assets sooner. Separately, the use of a third party trustee for the possession of client assets may result in a more expeditious transfer of those assets to the relevant clients following an insolvency (but would result in additional costs). HM Treasury has recently proposed the possibility of expediting the return of trust assets by administrators of financial institutions, but this would require legislative intervention.

Set-off rights and events of default

Difficulties: Some clients have found that they may not have sufficient set-off rights in the event of a financial institution insolvency. Under general insolvency law, set-off is required by a creditor of sums owed to a company in administration against sums due from that company. However, this rule only applies when the administrator gives notice that he intends to make a distribution, which occurs later in the administration process. A similar rule applies automatically when a company goes into liquidation. Many agreements with financial institutions only provide for set-off rights to be exercisable by the financial institution, not the client. In contrast to the position of the client, financial institutions' rights of set-off may on their face extend to

[2] *RAB Capital Plc, RAB Capital Market (Master) Fund v Lehman Brothers International (Europe)* [2008] EWHC 2335 (Ch).

client trust assets. Set-off rights may also extend to obligations of a client owed to group companies.

Solutions and mitigating steps: Clients should consider the scope of financial institutions' rights of set-off in terms of particular accounts and legal entities. Clients should also consider carefully whether they should use affiliates of financial intermediaries for lending or other activities which might give rise to the exercise of set-off rights. Client asset or custody accounts in particular should be free from cross-guarantees and unaffected by lending arrangements or unpaid fees to other legal entities. Importantly, agreements should provide for events of default, set-off rights and valuation mechanics exercisable by clients upon the insolvency of a financial institution. Such set-off rights should also include a valuation mechanic for non-cash obligations. These sorts of provisions in favour of clients should, in principle, be capable of benefiting from the protections of the Financial Collateral Directive,[3] which means that they should be exercisable and enforceable even following an insolvency of the financial institution.

Rehypothecation limits

Difficulties: In some of its agreements, Lehman had unlimited rights of rehypothecation or express rights to rehypothecate up to 180 per cent of required collateral. Assets in accounts in respect of which rehypothecation rights exist may potentially be subject to a client asset trust, to the extent that the assets in the accounts have not actually been rehypothecated. However, in principle, assets which have been rehypothecated, in circumstances in which no replacement assets can be identified, are unlikely to be capable of being subject to a client asset trust. Where assets have been rehypothecated, a client's claim is likely to be unsecured. In addition, in the US, there is a statutory limit of 140 per cent rehypothecation for broker-dealers.

Solutions and mitigating steps: Limits on rehypothecation can be agreed contractually between financial institutions and clients.

Clearing and OTC deals

Difficulties: In the *Global Trader* case, it was held that no proprietary claim was available in respect of "in-flight" transactions, i.e. transactions where assets had been instructed to be transferred to a client account but where the transfer had not been completed. For on-exchange and cleared transactions, a clearing house is able to complete all in-flight transactions at the point of insolvency pursuant to the Settlement Finality Directive[4] and provisions of its default rules. However, there is no such protection for transactions that are "over the counter" ("OTC"), i.e. that do not use exchanges, clearing houses, central banks or settlement systems. Open OTC contracts with an insolvent counterparty are not subject to the flexible close-out powers available to clearing houses, so the parties' rights will be governed by the terms of the contract following insolvency of a counterparty – and subject to general insolvency laws.

Solutions and mitigating steps: The subject matter of client asset trusts should be defined carefully and clearly in relevant documentation. The worldwide regulatory push for a greater number of contracts, such as credit default swaps, to be cleared at central counterparties (as opposed to OTC) should result in additional protections for in-flight transactions and open contracts. Clients should seek to take advantage of clearing arrangements for transactions where available by using financial institutions that are members of clearing houses and settlement systems.

The "alternative approach"

Difficulties: Under the "alternative approach" for client money, cash actually transferred by a client to an institution is not placed into a trust account. Rather, the institution sets aside an equivalent amount in a segregated account. The legal effects of this structure are unclear, given that reconciliations of the account do not involve payments to or from beneficiaries of the supposed trust. Particularly in the absence or an effective waiver of set-off, the bank at which such

[3] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

[4] Directive 98/26/EC of the European Parliament and of the Council on settlement finality in payment and securities settlement systems.

account is held may have no way of knowing that it is a trust account.

Solutions and mitigating steps: Clients may wish to consider contractual restrictions on usage of the "alternative approach" in favour of actual segregation of transferred cash under the "normal approach". Such structures may involve increased fees.

Client classification and opt outs

Difficulties: Financial institutions in Europe are required to classify each of their clients as: (i) eligible counterparties; (ii) professional clients; or (iii) retail clients. The client asset rules are mandatory for retail clients and generally apply for professional clients. However, professional clients can opt out of the client money rules by consent in writing. The rules will not as a general matter apply to eligible counterparties acting in that capacity.

When new client classification rules were introduced in November 2007,[5] many financial institutions re-papered clients, some seeking to place clients in higher categories and with as many 'opt outs' from regulation as possible, so as to decrease compliance costs. As a result, some clients may not have client asset protections available.

Solutions and mitigating steps: Clients that are classed as "professional clients" should ensure that they have not opted out of the client asset rules. Clients classed as "eligible counterparties" should reconsider whether that status is appropriate. Client classifications and opt outs can be changed in writing. If agreements between clients and financial institutions are renegotiated to reflect more robust insolvency arrangements, clients should consider withdrawing and then re-transferring all of their assets to ensure that the new arrangements apply to all assets.

[5] Pursuant to the Markets in Financial Instruments Directive (Directive 2006/73/EC).

This publication 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.

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

Barnabas W.B. Reynolds London +44.20.7655.5528 barney.reynolds@shearman.com	Ian Harvey-Samuel London +44.20.7655.5915 ian.harvey-samuel@shearman.com	Patrick Clancy London +44.20.7655.5878 patrick.clancy@shearman.com	Azad Ali London +44.20.7655.5659 azad.ali@shearman.com	John Adams London +44.20.7655.5740 john.adams@shearman.com
Thomas Donegan London +44.20.7655.5566 thomas.donegan@shearman.com	Donna Parisi New York +1.212.848.7367 dparisi@shearman.com	Geoffrey Goldman New York +1.212.848.4867 geoffrey.goldman@shearman.com	Azam Aziz New York +1.212.848.8154 aaziz@shearman.com	Bradley Sabel New York +1.212.848.7367 bradley.sabel@shearman.com