SHEARMAN & STERLING LLP

Client Publication

Financial Institutions Advisory and Financial Regulatory Group | December 23, 2009

More Lessons from Lehman: Protecting Client Assets held with UK-incorporated investment banking entities

The application of the FSA's client money rules to the Lehman Brothers administration is clarified to an extent by a recent decision of the High Court in London. Many of the conclusions and clarifications appear to be sensible. However, some aspects of the judgment, particularly as regards clearing, raise further questions.

The Lehman administrators applied for directions from the court on the application of the FSA's client money rules in Chapter 7 of the Client Assets Sourcebook ("CASS 7"). The judgment, which deals with 26 separate questions on CASS 7, was handed down by Mr. Justice Briggs on December 15, 2009 (the "Client Money Judgment").[1]

Section 139 of the Financial Services and Markets Act 2000 empowers the FSA to make rules providing for a statutory trust over client money held by UK-incorporated investment banking entities. These rules are set out in CASS 7 and effectively enshrine certain protections for client money and assets. The rules were amended in 2007 as a result of the Markets in Financial Instruments Directive, and it is that version which is the subject to the judgment.

Briggs J refers to CASS 7 as being "patently inconsistent and flawed in certain significant respects". Changes were made to the client money rules in January 2009 following the fall-out from the Lehman administration and other cases such as the Global Trader case which had already identified shortcomings in the rules.[2] Some of the points decided have already been superseded by rulebook changes. Nonetheless, this case is seen as taking a position on a number of the uncertainties remaining in the FSA's client money rules.

The Client Money Judgment is likely to inform the FSA's consultation on client money and asset rules, which is due in Q1 2010. In addition, a HM Treasury consultation paper[3] on the proposed resolution arrangements for investment banks (the "Investment Bank Resolution Consultation Paper") was published the day after the judgment and includes proposals on improving the system for returning client assets in the event of insolvency. The FSA will be mindful to ensure that in future its rules do not attract the same degree of criticism as they have in this case.

This memorandum discusses the practical implications of the Client Money Judgment. The impending review of the client money rules by the FSA and the Government may however change some of the effects of the judgment. The judgment is subject to an appeal, so some of the conclusions reached may be subject to further change.

The "alternative approach"

Under the co-called "alternative approach" the client money rules permit firms to receive client money into one of their own accounts and segregate money by setting aside an equivalent amount in a segregated account on a daily basis. This is to be contrasted with the "normal approach" of actually segregating client

[1] In the matter of Lehman Brothers International (Europe) (in administration) v CRC Credit Fund Limited and Others [2009] EWHC 3228 (Ch).

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

[3] "Establishing resolution arrangements for investment banks" 16 December 2009, available at http://www.hm-treasury.gov.uk/d/consult_investmentbank161209.pdf.

money upon receipt. The legal effects of the "alternative approach" structure have previously been regarded as unclear, given that it was not previously apparent in the FSA rules whether reconciliations of the account involve payments to or from beneficiaries of the trust.

Briggs J held that the statutory trust imposed by CASS 7 would arise upon receipt of client money either from the client or from a third party on behalf of the client, regardless of which account money is transferred into. Briggs J considered that this interpretation, as opposed to the interpretation that the trust only arises upon segregation of the client money, was correct.

This conclusion raises questions about whether a firm's own accounts will be considered to be trust accounts when the alternative approach is in use, giving rise to previously unforeseen liability and operational issues, and potentially restricting the scope of existing security arrangements (which cannot normally be applied to funds held on trust). The normal approach to client money may therefore become a more attractive option than had previously been considered to be the case.

Unsegregated client money

The failure of Lehman Brothers International (Europe) correctly to segregate client assets was strongly criticised by the judge. The Client Money Judgment confirms that only those clients with segregated client money are able to claim the return of their assets under the client money distribution rules. Clients whose assets should have been, but were not, segregated will typically be general creditors with no proprietary rights. It may be possible for such unsegregated clients to establish a tracing claim into any assets representing the original trust assets but such a claim would be hard to make in the context of a client money business such as investment banking. For example, if an account into which unsegregated assets are transferred has subsequently been overdrawn, this would destroy any possible tracing claim because the tracing claim is limited by the lowest balance on the account after co-mingling.

Clients should carry out systems and documentation due diligence on firms they place assets with to make sure that a firm does actually segregate client money.[4] The increased reporting and record-keeping requirements proposed in the Investment Bank Resolution Consultation Paper should be welcomed by investors as an aid to those due diligence efforts.

Client money pool

The Client Money Judgment holds that, in the event of an insolvency, assets of all segregated clients will be pooled. Entitlements in the client money pool are to be mutualised and calculated at the time of the onset of administration, not at the time of distribution. There is a reciprocal sharing in losses (and gains) of the pool thereafter. The administrators are not obliged, under the CASS rules or general law, to top up any shortfall in the pool, either from identifiable unsegregated client money or from the general assets of the insolvent firm.

The overhaul of the client money rules in January 2009 amended certain of the provisions relating to the pooling and distribution of client money. Therefore, insofar as the judgment relates to the application of those CASS rules specifically, it is of restricted effect. However, several aspects of the Client Money Judgment, particularly about the timing of entitlements, will remain relevant today.

In the Investment Bank Resolution Consultation Paper it is proposed that there should in future be a series of separate client pools for different businesses of a firm, not one pool. The aim would be to reduce the likelihood of less risky investments being subject to the shortfalls which may arise from riskier investments.

Clearing Houses: client transaction accounts

The Client Money Judgment deals with 10 particular customer accounts held at various clearing houses. These include accounts where Lehman effected

[4] Solutions and mitigating steps to this issue, amongst others, were discussed in our client publication "Holding Financial Assets with UK Financial Institutions: Lessons from Lehman, Global Trader and the Financial Crises" dated October 1, 2009. The publication is available at http://www.shearman.com/holding-financial-assets-with-uk-financial-institutions-lessons-from-lehman-global-trader-and-the-financial-crisis-10-01-2009/.

margined transactions on a principal-to-principal (as opposed to an agency) basis. It is unclear whether the relevant assets were provided to clearing houses through security-based arrangements or title transfer-based arrangements. Briggs J held that all of the accounts at clearing houses constituted client money accounts. He also held that the interests of the clients in those accounts were to be determined at the time of the onset of administration.

In our view, the first conclusion is overstated and the second point is wrongly decided in relation to clearing houses. Notably, Part VII of the Companies Act 1989, the key legislation relating to the position of clearing houses on an insolvency of a member, was not cited. Pursuant to Part VII of the Companies Act 1989, the default rules of clearing houses take precedence over any moratorium applicable on the onset of insolvency and actions taken by clearing houses are insulated from insolvency claw-back.

The terms of clearing house default rules are largely prescribed by paragraphs 21 to 24 of the Schedule to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001, as amended. Pursuant to the relevant legislation, under the default rules of clearing houses, open contracts of a defaulter (including customer account contracts) may be closed out or transferred over a period of time. There is then an accounting for losses, and gains, an application of collateral against losses, and finally a calculation of an amount due in respect of customer transactions and a separate amount due in respect of house transactions. Upon the completion of that process, a "net sum" is declared due and payable to or from the clearing member: one for the customer account and one for the house account.

Traditionally, neither of the UK's two main clearing houses (LCH.Clearnet and ICE Clear Europe) treat assets in their hands as client money. Rather, the assets are generally regarded as beneficially owned property of the clearing house, or property held by the clearing house under security arrangements, which can be applied against losses of their member without restriction due to the existence of beneficial interests of customers in such assets. Were the assets to be beneficially owned by customers of clearing members, this could destroy mutuality between collateral and liabilities of members to clearing houses and potentially could prevent clearing houses from using collateral to meet losses on a default. The conclusion from the Client Money Judgment is therefore not consistent with the documentation used by clearing houses or the requirements of the Companies Act 1989. One could potentially consider the receivable of a clearing member in respect of its client account to be subject to a statutory trust (as opposed to the assets recorded in the account). However, even this approach would be inconsistent with the rights of clearing houses which receive collateral on a title transfer basis. The client money and asset rules are clear that title transfer collateral arrangements (and collateral re-use) destroy client money interests (e.g. CASS 3.2 and CASS 7.2).

A second difficulty flowing from the Client Money Judgment is that the entitlement of clients in all client money accounts should apparently now be determined at the time of onset of administration or the "primary pooling event", as opposed to at a later time when a loss is realised or contract is closed out. This is a questionable interpretation for accounts at clearing houses because the net sum declared by a clearing house following completion of its default proceedings is of probative value in insolvency proceedings under section 163 of the Companies Act 1989 and will have been based upon prices calculated during the course of the close-out process. Furthermore, all clearing houses in the UK allow for the transfer of customer contracts to solvent clearing members. It would be surprising were customers whose contracts and margin had been removed entirely from the customer pool to retain a proportional beneficial interest in amounts due under contracts of other customers whose contracts are closed out rather than transferred. This would result in a cash windfall for those customers whose assets had been moved elsewhere. The case appears to be incorrectly decided on these points and it is to be hoped that these matters will be subject to an appeal.

Rights of set-off

Briggs J held that general set-off rights are not exercisable by a firm against money held in a client money account. As a result, if the client owes money to the firm, the firm cannot dip into a client money account in order to set off the obligations owed. Instead, the firm must pursue the customer for the amounts separately.

The judgment confirms the orthodox position that insolvency set-off is only available where there is a relationship of mutuality, not where some assets are subject to a trust. In any event, Briggs J stated that, unless a client is also insolvent, it should pay its debt to the firm in full. This does not affect security arrangements which may still be established between the parties.

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

BROADGATE WEST | 9 APPOLD STREET | LONDON | EC2A 2AP | WWW.SHEARMAN.COM