What's Broken With the UK's Client Asset and Money Protections and How to Fix it

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The issue

The provisions of the Market in Financial Instruments Directive (MiFID)[1] and the rules of the Financial Services Authority (FSA) on the protection of assets, including money, belonging to a firm's clients (as found in the "CASS" sourcebook of the *FSA Handbook* of rules and guidance) might reasonably be taken to imply that client assets and money held by an institution are generally protected, including on the institution's insolvency. However, this is not always the case. The interaction between CASS and English law leaves such assets susceptible to various operational risks, such as those arising from inaccurate record-keeping on the part of the institution itself, with the consequent risk for investors who have given assets or monies to the institution of having to share resulting losses with unconnected clients. The law should be capable of protecting against those risks in many circumstances without the imposition of any unduly onerous duties on institutions.

Although there has recently been detailed judicial analysis of certain aspects of the current legal position, particularly in the context of client money, and interpretations have evolved in an effort to achieve the fairest possible results, the upshot is that the flaws in the overall scheme have merely become clearer. The analysis in the recent cases has largely turned on the application of the CASS rules, especially those on client money. The rules at present provide for certain, albeit limited, protection to be given to monies held for clients by firms. The protection is limited because monies are only given meaningful protection when in the so-called client money pool; and the rules operate so as to distribute losses across the entire base of clients with entitlements to client monies. Within this context, a relatively narrow view was taken of the scope of client money protections by first instance judges in the *Lehman Brothers*[2] and *Global Trader*[3] cases. Monies were only subject to the CASS client money pooling mechanics when paid into a client money account. Before that time they were client monies not subject to pooling and only recoverable if traceable, which will often be impossible. In both *Lehman Brothers* and *Global Trader* the investment bank had not fully complied with CASS, particularly in relation to segregation of the client monies. Client entitlements were wrongly recorded and monies were largely untraceable. As a result, some clients suffered unforeseeable losses against which they could have taken little precaution. The Court of Appeal in *Lehman Brothers* took a slightly wider view. It held that monies placed on behalf of clients into what would otherwise have been house accounts pending segregation into client money accounts are also to be treated as subject to the client money pooling arrangements, and investors could make claims against this wider client money pool to the extent of their client money entitlement. However, for reasons set out more fully below, even on such an approach the issue remains that, in the absence of accurate record-keeping and reconciliations by the investment bank, clients' proprietary protections in assets wrongly accounted for are limited, and clients are unlikely to achieve full recovery in respect of their "entitlements".

Property law operates in a somewhat arbitrary manner in protecting entitlements in this context. Rules developed in the last century and before, in the context of very different types of (slower-paced) dealings and assets, balanced the interests of owners and other third parties in a way that achieved plausible fairness. However, many of the concepts used to achieve that fairness in an earlier world do not achieve such an outcome so easily in the context of fungible, intangible property that is recorded by way of book entries and the subject of rapid, overlapping trades. The need for appropriation of assets before any entitlement arises for the beneficial owner means that, if assets are not actually segregated or recorded in an individual client's name but are instead subject to pooling and dealings intermingled with the dealings of other clients or the firm itself, actions of the investment bank are likely to be determinative of entitlements in a context difficult (if not impossible) to scrutinise fully. The rules on tracing, although sensible, are of limited use when assets are moved quickly from

[*] The views expressed in this note are personal to the authors.
[1] Directive 2004/39 on markets in financial instruments [2004] OJ L145/1 (the Markets in Financial Instruments Directive).
[2] *Lehman Brothers International (Europe) (In Administration), Re* [2009] EWHC 3228 (Ch).
[3] *Global Trader Europe Ltd (In Liquidation), Re* [2009] EWHC 602 (Ch).

one account to another, pooled, re-segregated, re-hypothecated and transformed. Given the automated nature of the processes involved, third parties will almost always be bona fide purchasers. The question is whether the principles of equity, together with regulations, can be used to develop the law in a way which properly addresses these issues (and whether the courts and regulators are willing to do so), or whether more significant intervention is required.

HM Treasury and the FSA have recognised that the law on client assets merits reform. They have published separate proposals to afford enhanced protection to client assets and money. However, these proposals deal mainly with various technical issues arising from the financial crisis, for instance in relation to the provision of information to clients, as well as the restriction of custodian liens and on the placement of monies with intra-group entities. The proposals do not address the issue of whether clients of a financial institution who provide assets to that institution for trading on their behalf should find themselves to be general creditors in respect of assets where there is a shortfall in the pool or which are otherwise untraceable, or whether instead they deserve to rank ahead of such creditors or otherwise have entitlements to assets that fall outside the insolvent estate. The proposals made to date also fail to deal with a number of technical difficulties affecting the current client money rules.

A wide-ranging consideration of the issues and the state of the current law is called for. We set out below some possible approaches for reform. In particular, we suggest exploring possible changes to insolvency law or extending the boundaries of the statutory trust imposed by CASS so that a firm's clients always rank ahead of general creditors or their assets fall outside the insolvent estate.

Outline of the current situation

The practicalities of client property

Financial institutions provide certain types of service to clients which enable them to access the financial markets, through the institution, on an efficient basis. The institution takes in client assets or money for the purpose of trading and investing activities. Depending on the size of the client's portfolio it may then pool those assets and money and engage in trading in the financial markets either as agent for the client(s) or on a back-to-back basis as principal.[4] Many types of trading in the markets, such as repo and derivatives trading, are generally required to be undertaken by the institution as principal.

In principal trades, institutions often have to "pre-fund" positions with their counterparties in advance of receiving consideration from the clients or in anticipation of converting client assets into a more appropriate source of funding or collateral. Institutions often also have to convert client assets into other assets for delivery to a counterparty or clearing house in a form required by market dealings. For instance, clearing houses require narrow forms of security to be provided with the result that the institution is likely to have to convert client assets into the types of instrument required by clearing houses before it can collateralise client positions using the client's own assets—"collateral transformation". Pre-funding may occur in the interim (or even on an ongoing basis). Profits arising on positions entered into by an institution on behalf of clients typically have to be collected and allocated. Some payments due to clients such as dividends on shares are "manufactured", in as much as they are declared as a contractual matter on the basis of arrangements between the institution and client only. This enables clients to assume synthetic positions that replicate the economic exposure the client would have had if it had actually acquired a particular investment directly, such as a share.

There is considerable variation in the terms and conditions of business pursuant to which client assets and monies are taken. Sometimes the institution has the power to "rehypothecate"—i.e. re-use assets at a time of its choosing, thereby converting a beneficial entitlement into a merely contractual one without (subject to possible further regulatory requirements) the knowledge of the beneficiary. Sometimes the institution is entitled to treat the assets as its own (particularly, in the wholesale markets context, collateral provided pursuant to title transfer arrangements, such as under repos and stock lending); and on the basis of a valuation and at a time of its choosing. Sometimes the assets are left in situ but the client's ownership interest can only be determined in light of the cost of positions and any margin held or placed on back-to-back derivatives and other contractual investments where the institution acts as principal. In such cases, the institution often enters into such contracts for the benefit of a number of clients at once and without necessarily drawing on the client's account at the outset or updating its records to specify which clients are interested in which investments. Positions acquired in such a way can accrue profit or margin which can be returned, but this may not be calculated or allocated instantaneously to particular clients.

Although the matter has not to our knowledge been investigated scientifically, we suspect many clients would assume, in part by virtue of the conduct of those involved and in part by virtue of much-vaunted legal protections set out in MiFID and CASS, that their assets are generally traceable into whatever positions, profits, assets and, more specifically, monies are held on their behalf by the institution. This of course glosses over matters of

[4] Dealing as a back-to-back principal is also known as "matched principal broking". Matched principal broking results in the institution having a fully hedged position in a financial instrument and may be contrasted with ordinary market-making in which an institution stands ready to deal in a particular financial instrument on both the buy and sell sides, even if the institution is not always able to hedge a particular position. When market making, financial institutions usually trade at a sufficient spread between buy and sell prices to offset the risk of any market movements causing losses to the institution. This article is concerned only with matched principal trades and other principal trades where an institution hedges its positions with clients by entering into trades with counterparties.

considerable legal complexity. However, in so far as the law is capable of being made to fit expectations without interfering with the financial institution's practices or liabilities or indeed market practice in trading and making investments more generally, we suggest that this matter is something that merits thorough consideration.

Current legal protections

CASS: client assets

Firms are required to make adequate arrangements to safeguard clients' ownership rights, especially in the event of the firm's insolvency, and to prevent the use of a client's assets on the firm's own account except with the client's express consent.[5] Client assets are typically held in segregated or pooled[6] accounts at custodians or underlying depositories, giving rise to a trust relationship in English law.[7] The FSA's custody rules in CASS 6 contain a number of provisions on how firms must record legal title to client assets and on the depositing of such assets with third parties.[8] There are restrictions on the recording of legal title to client assets as well as requirements to keep proper records to enable identification of client assets. A trust does not of course arise, or if there is one, it disappears, where the institution takes or converts assets by way of a title transfer financial collateral arrangement (see *Issues regarding holding of collateral* below).

CASS: client money

Non-bank financial institutions hold client monies, as they are required to do, in trust accounts at third party banks. Client money is nowadays mostly in non-physical form.[9] The requirement for it to be placed in an account with a third party bank and the characterisation of that account as a trust account arises from the rules in CASS. CASS 7.7.2R imposes a trust over the account receivable constituted by the institution's rights as depositor of the client money account. This trust has been imposed under powers granted to the FSA by s.139 of the Financial Services and Markets Act 2000 (the FSMA).[10] In similar fashion to the custody rules, the client money rules impose various client protections, contained in CASS 7 and 7A, including a requirement on the firm to secure a waiver of set-off from the third party bank at which the client money account is held.[11]

Complexities arise where the institution is a bank itself and does not wish to use the services of a third party institution. The client money rules do not apply in such a case.[12] Arguably the client is in no worse a position than a client of an investment firm holding client monies with a third party bank since in both cases the client is ultimately exposed at least to a certain extent to a bank's insolvency risk. Banks are subject to higher capital requirements than investment firms and to depositor protection schemes. With an investment firm the client bears an additional record-keeping and operations risk arising from the trust account arrangements operated by the firm. Issues nevertheless arise as to client protections where client monies are "held" by a bank on its own balance sheet. These merit consideration. However, for simplicity, the following discussion will focus on client monies held with a third party bank.

Once client monies are received into a bank account by a firm, they are held on trust from the moment of receipt subject to the client money rules and the client money distribution rules.[13] CASS permits two approaches to the holding of client money, termed "normal" and "alternative". Under the normal approach, a firm must promptly, and in any event no later than the next business day after receipt, deposit all client money into a segregated client account with a third party bank.[14] This may be either a general client account where client monies are pooled or a designated client account where the client money from one or more clients is deposited to the exclusion of other clients. Notifications are required as a matter of regulation to be made to the third party bank to make it aware that the account is a trust account, and waivers must be obtained from the bank so as to prevent set-off against monies held on behalf of the institution itself. Issues may arise when such notifications or waivers of set-off have not been made, but generally even an ex post facto notification may (from experiences in *Lehman Brothers*) be respected by some third party banks.

Under the "alternative" approach, a firm deposits client monies directly into its own general bank account, the house account, at the point of receipt.[15] The firm is then required to carry out end-of-day reconciliations to determine the daily client money requirement, i.e. the total amount of money that constitutes client money required to be segregated. The firm must then immediately reconcile the client money account with the requisite amount. Intra-day the client money account must contain

[5] CASS 6.2.1R.
[6] Where there is pooling, there should be a co-interest. A trust over a pool of fungible *choses in action* does not require the setting aside or identification of particular shares: *Hunter v Moss* [1994] 1 W.L.R. 452 CA (Civ Div).
[7] The existence of a trust may be defeated if the agreement between the firm and the client validly provides that the firm does not hold the assets as trustee. If this is the case, the client would have a mere contractual right to the return of assets.
[8] It is nowadays quite rare for legal title to many financial instruments to be evidenced by a physical certificate. Instead, legal title to financial instruments is typically evidenced by book entries on the books or records of a securities depository.
[9] Money market fund shares or units are also subject to the custody rules in CASS 6.
[10] Section 139 enables the FSA to impose a trust in relation to client money held by an FSA-authorised firm. The FSA has utilised this power by setting out the terms of a statutory trust in CASS 7.7.2R. A firm "receives and holds client money" as trustee in accordance with, and for the purposes of, certain rules in CASS: CASS 7.7.2R.
[11] CASS 7.8.1R. This prevents the bank from setting off any credit balances on client money accounts against any amounts owed to the bank by the firm on any other accounts.
[12] CASS 7.1.8R.
[13] Briggs J. in *Lehman Brothers* [2009] EWHC 3228 (Ch).
[14] CASS 7.4.14G and 7.4.17G.
[15] CASS 7.4.14G, 7.4.16G, 7.4.18G and 7.4.19G.

a buffer in an effort to ensure adequate monies are segregated on clients' behalves in case of insolvency. Under this approach, a firm's house accounts may, intra-day, contain a mixture of client money and the firm's own money. The Court of Appeal in *Lehman Brothers* treated such house accounts as also being subject to the statutory trust and subject to pooling with money in client money accounts.[16] The house account will most likely not have been subject to any waiver of set-off by the third party bank so the monies are likely more exposed than monies held in a proper client money account.

CASS contains rules dealing with the distribution of client money in the event of a firm's insolvency or other failure.[17] On the occurrence of a "primary pooling event",[18] which includes the onset of an administration or insolvency of the institution, client money held by the institution in every type of client money account (including money in any designated, or segregated, client accounts and, after the Court of Appeal decision in *Lehman Brothers*, house accounts containing client money) is treated as pooled. Each client is interested in the pool based on its entitlements to client money, i.e. rateable to its client money entitlement as a fraction of the total entitlement of all clients of the institution.[19] The statutory trust requires the firm or the insolvency practitioner to distribute the monies in the client money pool in order to satisfy the claims of clients in accordance with their respective interests, subject to a deduction for payment of any costs properly attributable to the distribution of the client money, the remainder being payable to the firm itself.[20]

There is no recognition of individual account segregation at present, so a client who has carefully audited an institution's record-keeping in relation to its own monies will be exposed to losses on client accounts held for other clients, including accounts held in entirely different areas of the institution's business (which most likely could not practicably have been audited by the first client).

In light of the Court of Appeal's decision in *Lehman Brothers*, any house accounts into which client monies were deposited prior to any reconciliation with true client money accounts will count as client monies and be included in the pooling.[21] A client's entitlement or share in the client money pool is calculated on the basis of what ought to have been segregated for that client, and not merely what was actually segregated for it by the firm.[22] Furthermore, it is not only those clients for whom money has been segregated or who have contributed to the client money pool that share in the client money pool. The Court of Appeal held that those clients with a merely contractual entitlement to client money will also share in the client money pool.[23] It is difficult to see how this can be applied in practice in the context of complex dealings, where contractual entitlements will be difficult to determine in a manner detached from a calculation of what is in the client money pool—not least since contracts do not generally (and probably cannot at all easily) specify what is to be client money.

Notably, not all obligations to clients will give rise automatically to client money. For instance, the Court of Appeal in *Lehman Brothers* held that any "self-generated indebtedness" of the firm would not become client money unless and until the firm had appropriated a sum for that client. There was no deemed appropriation in such instances. A mere debt owed to the client, for example a "manufactured dividend" in a stock-lending transaction where the firm has borrowed the client's securities (and resold or on-lent them) and acknowledges an obligation to pay a sum equivalent to the dividends on those securities to the client, leaves the relationship as one of debtor-creditor, and the firm has a mere contractual liability to pay a sum to the client.[24] There would only be client money if the firm actually segregated additional funds in respect of the obligation and placed them in a segregated client account.

Aspects of the High Court's judgment in *Lehman Brothers* dealing with trades that are cleared by a clearing house should be treated with caution, given that it seems that the court was not presented with a complete description of the mechanisms of central clearing, the manner in which clearing houses take collateral or legislation relating to clearing houses. No consideration seems to have been given to the fact that many clearing houses take collateral by way of title transfer, and that there is a bespoke regime for an institution's insolvency at a clearing house, contained in the Companies Act 1989 and the Financial Markets and Insolvency (Settlement Finality) Regulations 1999[25] and the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001,[26] which provides for a post-insolvency process leading to the calculation of a "net sum" owing on client positions. The interaction between that net sum and the client money rules is unclear (not least since it was not properly considered by the courts). There is a similar and

16 *Lehman Brothers International (Europe) (In Administration), Re* [2010] EWCA Civ 917 at [78]–[107].
17 CASS 7A.
18 CASS 7A2.2R. A secondary pooling event occurs on the failure of a third party to whom client money has been transferred under CASS 7.5.2R (i.e. a clearing house, exchange or intermediate broker) or with whom client money is deposited under CASS 7.4.1 (i.e. the third party bank with which the client money account is held). If there are both primary and secondary pooling events, as in *Lehman Brothers*, then the rules for primary pooling apply: CASS 7A.2.11R.
19 CASS 7A2.4R.
20 CASS 7.7.2R.
21 *Lehman Brothers* [2010] EWCA Civ 917 at [124]–[142].
22 *Lehman Brothers* [2010] EWCA Civ 917 at [143]–[164].
23 *Lehman Brothers* [2010] EWCA Civ 917 at [143]–[164].
24 *Lehman Brothers* [2010] EWCA Civ 917 at [165]–[176].
25 Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (SI 1999/2979).
26 Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (SI 2001/995).

parallel EEA-wide regime introduced by the Settlement Finality Directive[27] which allows "designated" clearing houses and settlement systems to liquidate all open positions with a view to arriving at a single net sum payable by or to an insolvent participant.

The assumption appears to be that all customer accounts are "client transaction accounts". Accordingly, any net sum arising from a clearing house customer account falls into the client money pool, and the so-called "equity balances" in customer accounts are assimilated into the primary pooling event calculation methodology along with monies held at third party banks. This would be the case where the monies are provided under CASS 7.5.2R, under which a firm may allow a clearing house, exchange or intermediate broker to hold client money if this is done for the purpose of a transaction for a client with or through that person or to meet an obligation to provide collateral for a transaction undertaken for a client. Any monies provided to a clearing house under CASS 7.5.2R will be recorded in client transaction accounts and hence any net sum derived from client transactions recorded in such accounts will fall within the client money pool.

However, the position requires more thorough consideration where cash collateral has been provided under a title transfer collateral arrangement either to the clearing house or to a clearing member or both so that it no longer constitutes client money. Such monies should arguably not form part of the client money pool, nor should positions collateralised by such monies be taken into account in calculating the client's client money entitlement. That said, any receivables held by the firm which are referable to client transactions (such as any net sum due from the clearing house) should be subject to a separate trust and a separate regime from that governing the client money pool. Alternatively, monies held against client positions at clearing houses could be treated as falling outside the client money pool and instead be ring-fenced in such a way that they are to be returned to clients directly under a provision in CASS that deals with client monies received after a primary pooling event.[28] This would mean that customers with centrally cleared positions could end up in a safer position than customers with non-cleared positions. On the face of it such an outcome might appear fairer since they should be treated as having an exposure solely to the clearing house and they are prevented from being directly exposed to the clearing house's credit by virtue of the fact that only significant financial institutions are capable of being members of clearing houses. However, the point is unclear. For such a treatment to arise the monies would have to be seen to be client monies received after the primary pooling event. The question of whether the monies are client monies is moot: see *Issues regarding holding of collateral* below. Furthermore, the judgments in *Lehman Brothers* did not distinguish between assets passed to clearing houses on a title transfer basis and those passed on a pledge or other basis, and the decisions assumed that all assets, however passed to the clearing house, should fall within the client money pool.

Separately, the client money rules do not prevent clearing houses from creating bespoke, robust client protections distinct from the client money trust. Many clearing houses are currently attempting to establish such arrangements.

In both of the preceding contexts, which relate to title transfer collateral provided to clearing houses and the wish on the part of clearing houses to offer more robust protections than those available under the client money rules, the finding in the *Lehman Brothers* first instance decision that all accounts at clearing houses are client transaction accounts is unhelpful and may well have been wrong.

Rules on tracing

Tracing is an equitable process which allows a beneficiary of a trust to identify certain replacement assets in cases where trust assets have been substituted with other assets. The principles of tracing were primarily devised to assist beneficiaries in reclaiming any trust property that had been misapplied by their trustee. Nonetheless, these principles are of little help to clients who have lost their proprietary entitlements because of a financial institution's failure to comply with its regulatory duties. The rapidity and juxtaposition of market transactions, and the fact that automation means that most counterparties are bona fide purchasers for value, means that tracing will rarely be of much assistance to a client faced with a shortfall.[29]

Even though there are punitive presumptions that require the trustee to prove that any property dissipated from a mixed fund is specifically attributable to the beneficiaries,[30] these presumptions are of little help if the amount in the fund has fallen below the client asset or money entitlement. Furthermore, if the clients' money has been dissipated by being used to pay for general expenditure or to discharge liabilities, the clients will have no property to which the trust can attach. Thus, where a trustee pays trust money into an overdrawn account and, as a result, eliminates the overdraft, the beneficiaries will lose their ability to trace since the creditor under the overdraft (i.e. the bank) will ordinarily be a bona fide purchaser for value.

There is a further important qualification to the ability to trace in the case of client money. Following the Court of Appeal judgment in *Lehman Brothers*, because the statutory trust over client monies is a single trust, the right

[27] Directive 98/26 on settlement finality in payment and securities settlement systems [1998] OJ L166/45, implemented in the UK by the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (SI 1999/2979).
[28] CASS 7A.2.7R.
[29] This was noted in *Global Trader* [2009] EWHC 602 (Ch) at [60] and [110].
[30] See for example *Tilley's Will Trusts, Re* [1967] Ch. 1179 at 1183 per Ungoed-Thomas J.: "if a trustee mixes trust assets with his own, the onus is on the trustee to distinguish the separate assets, and to the extent that he fails to do so, they belong to the trust."

to trace is exercisable by the beneficiaries as a whole. There is accordingly no right to trace for individual clients in relation to monies to which they are themselves entitled.

Shortcomings in the current regime

Protection of client entitlements dependent on firm compliance with duties

The current regime fails to protect client expectations where:

(a) assets have not been segregated or recorded as client assets and the relevant account has fallen with the result that the client's entitlement has been wiped out and tracing is not possible because of the minimum balance rule;

(b) where there is a shortfall in the client money account and the monies in the relevant house account are insufficient because:

- (i) they have been used to pay for expenses of the institution;
- (ii) they have been used for house or omnibus client trades and the error has become buried such that the positions cannot be traced or the minimum balance rule applies in relation to one of the accounts through which assets have passed in such a way as to wipe out any client claims;
- (iii) the third party bank holding the (mixed) house account sets off the amount in the relevant house account against monies separately owed to it by the institution because it made no waiver of set-off and was not notified of the client money trust; or
- (iv) the effect of pooling of all client money on a primary pooling event is that losses borne on an entirely different part of the business are to be suffered by the innocent, even watchful, client in question.

Accounting errors on the part of an institution may be deliberate but more likely will result from technical or inadvertent human errors which, cumulatively and over time, lead to client assets and monies becoming hard to identify. Reverse engineering of client entitlements is likely in such a situation to be expensive and often difficult. As the law stands, the expense of working out, or even attempting to work out, client entitlements falls on the clients.[31] This means that where the distribution of client money is delayed or disrupted because of the regulatory failures of the firm, including failure to keep adequate records or to carry out reconciliations, clients will bear the considerable expense of having their entitlements determined and distributed to them. This is what is currently happening in the *Lehman Brothers* litigation. The position is one of questionable fairness.

In addition, the Court of Appeal approach in *Lehman Brothers* appears to be of arbitrary effect. If there is a buffer in the client money accounts, and client monies in a house account, then certain general creditors' monies (but not others) are effectively swept into client money pooling. There is a certain fairness to the additional protections provided to client money holders, but the situation is arbitrary in as much as it depends on the extent to which a firm has provided for any buffer and the extent of any house monies pulled into pooling as a result of this mechanism. The entitlements basis for distribution should mean there is no absolute windfall for clients, but the extent of any losses as a result of inadequate record-keeping and client money management will vary. If there is a minor omission and monies are in a house account when they should have been swept into a client money account, the clients may find themselves made whole. If there has been a more complex or dramatic failure the clients may find themselves entirely unprotected.

The UK Government believes that clients have a legitimate expectation that they will get their property back in the event of an investment firm's insolvency. HM Treasury has stated that:

> "[t]he Government takes extremely seriously the protection of clients' proprietary rights and believes that client money should be easily accessible to an administrator or trustee on insolvency so that it can be returned promptly …"[32]

The fact that a client may suddenly find itself treated no differently from general creditors is a significant flaw in the current regime. Persons who lend money to a financial institution on an unsecured basis do not expect to have recourse to the client asset or money pool. They price their lending based on the risk that they will be treated as an unsecured creditor. By contrast, clients normally expect that they will retain proprietary rights in any assets that are held on their behalf by a financial institution and many do not consider that they need to carry out detailed assessment of the institution's credit risk. Nor will the economic terms of the transaction typically incorporate a risk premium or other compensation reflecting the credit risk of the firm.

[31] CASS 7.7.2(4)R.

[32] HM Treasury, *Establishing resolution arrangements for investment banks* (December 2009), para.4.67, at *http://www.hm-treasury.gov.uk/d/consult_investmentbank161209.pdf* [Accessed October 8, 2010].

Rights of "rehypothecation"

Many agreements between financial institutions and their clients (in particular, prime brokerage agreements) contain clauses that permit the institution to use the client's assets in its own business, for example, by disposing of such assets or using them as collateral to obtain funding for general business purposes.[33] Once the firm exercises such rights of re-use, the assets and money re-used by the firm will no longer fall within the custody and client money rules.[34] Because the firm's counterparty will have transacted for value, the clients will have no ability to trace.

There is some uncertainty as to the status of assets that are subject to a right of re-use, and the status of any replacement assets. Where a right of re-use has been exercised, the clients are generally treated as having a mere contractual right to the return of assets without any beneficial interest in any replacement assets that the firm has acquired using the proceeds of sale of the client's assets. This is the apparent intent behind the financing aspects of the prime brokerage arrangement. Prime brokers claim that such rights of re-use enable them to offer funding at attractive rates to their clients. However, if the prime broker seeks to take on positions for the client as principal, it is arguable that the receivable or any replacement assets should be seen to be subject to a trust in favour of the client. We understand this point will be tested in a further *Lehman Brothers* case in the near future.

More detailed provision could be made in the Financial Collateral Regulations[35] in respect of rehypothecation to achieve the result that the default position is that clients retain a residual beneficial interest in the assets subject to a right of re-use, as well as in any replacement assets, unless the agreement between the client and the firm makes it clear that the client only has a contractual right of return and specifies the circumstances when that is the case. We suspect no such provision was made when the Financial Collateral Regulations were introduced, in order deliberately to avoid "gold plating". However, the English law trust regime will only operate effectively in this context if greater clarity is provided as to how it inter-relates with the Financial Collateral Regulations. Civil law countries do not face this issue.

Lacuna in relation to receivables

Although a mere liability of a firm to its clients, for example in relation to manufactured dividends or similar self-generated indebtedness, cannot give rise to a trust relationship, the firm's rights as against its counterparty which are back-to-back with the firm's liability to its client could be made the subject of a trust in favour of the client. Typically, where a firm has entered into numerous trades on behalf of clients on a back-to-back principal basis with a counterparty, the firm will hold valuable property in the form of its rights against the counterparty which are referable to monies or assets that the clients have provided to the firm.

CASS does not contain any explicit provisions in relation to the firm's rights and receivables that are referable to and ultimately funded by client monies or assets. The current legal position is debatable. The firm could better hold any such rights and receivables on trust for its clients and itself in proportion to their respective interests in the transactions from which such rights and receivables arise. This issue is discussed further at *Issues regarding holding of collateral* below.

Clients with designated accounts pooled with other clients

Under the current regime, upon the occurrence of a primary pooling event the client money pool consists of all the client money held by the firm, including any client money in designated client accounts.[36] The rules do not create a separate pool for those clients whose monies have been deposited in a client account designated for their monies only. Thus, the monies of clients who specifically ask for a designated client money account for their business are pooled with those of clients who have not taken this precaution. This results in clients with designated accounts not being able to protect themselves by auditing the books of the firm. They have to bear the risk of any shortfall in the overall client money pool, even though the shortfall arises due to deficiencies in relation to an entirely separate part of the business which they were in no position to monitor.

Issues regarding holding of collateral

Firms such as Lehman Brothers International will undertake a range of transactions in securities or investments on behalf of their clients. The transactions may be spot contracts (i.e. contracts for the sale and purchase of a particular investment such as a bond, share or note for immediate delivery) or derivative or other ongoing contractual arrangements (such as repos, contracts for differences, futures, options or swaps). Most transactions in the wholesale financial markets take place on a principal or "riskless principal" basis. Where this is the case, the client enters into a transaction with a firm as principal and the firm will then enter into a transaction of the same kind with various counterparties as principal. Often, firms will aggregate orders from clients before entering into a transaction with a counterparty. Where a

[33] The benefit to clients in agreeing to rehypothecation takes the form of reduced cost of funds borrowed from a prime broker, and possibly reduced costs of the prime brokerage service as a whole.
[34] CASS 3.2.3G and 7.2.5G. The firm will still be subject to certain record keeping requirements.
[35] Financial Collateral Arrangements (No.2) Regulations 2003 (SI 2003/3226). These Regulations implemented Directive 2002/47 on financial collateral arrangements [2002] OJ L168/43 (the Financial Collateral Directive) in the UK.
[36] CASS 7A.2.4R(1).

firm acts as riskless principal, it will have, for each contract with a client, a matching back-to-back contract of the same kind and size with a counterparty.

Most transactions undertaken in the financial markets will involve the posting of collateral to secure the obligations of one of the parties. For example, where a client undertakes a long position in a futures contract, it will post initial margin, which reflects the collateral required to cover the possible future close-out losses on the transaction, and variation margin, which is posted to take into account (normally daily) fluctuations in the value of the position. Variation margin is often a misnomer since it frequently constitutes a (non-returnable) daily reconciliation payment for a position so as to reflect its current value. In both principal and riskless principal trades, the firm will collect margin from a number of clients and then pass on such margin to its counterparty, although firms often demand higher margin from their clients than they are required to post to their counterparties by reason of differences in collateral models, credit risk and variation margin collection times.[37]

The Financial Collateral Regulations[38] allow financial institutions to take collateral by way of a security financial collateral arrangement or title transfer financial collateral arrangement. Assets or monies that are posted as collateral pursuant to a title transfer arrangement will cease to be subject to the client money and custody rules.[39] The client who posts collateral by way of title transfer will therefore cease to have any beneficial interest in the collateral assets or monies.

Although clients will cease to have any interest in the assets or monies transferred as margin to a financial institution by way of title transfer, the transaction that the financial institution enters into with its counterparty is clearly referable to the transactions that the clients have entered into with the financial institution.[40] Typically, the transaction between the financial institution and its counterparty will be governed by standard terms that aggregate all the transactions between the institution and its counterparty for the purposes of set-off, so that, in the event of default, all transactions are closed out and the parties' profits and liabilities under all transactions are aggregated and set off against each other to arrive at a net sum due from one party to the other.[41] Furthermore, any gains on an open position due to fluctuations in market prices that accrue to a financial institution may trigger an obligation on its counterparty to transfer back to it any excess collateral that it holds, or to make a true-up payment. It is arguable that clients should have some beneficial interest in the contingent receivable which the net sum and the obligation to retransfer excess collateral or to make a true-up payment represent. Arrangements between clients and financial institutions do not usually provide for such a beneficial interest to arise, although in the clearing context there is a trend towards granting clients a beneficial interest in the net sum due on transactions that are referable to their business. The CASS rules do not make any provision in relation to the contingent receivable that a financial institution holds and which is referable, in part, to transactions that clients have undertaken with that institution. The current legal position is untested. It is therefore desirable to explore the possibility of imposing a statutory trust that attaches to any such receivables similar to the trust that is imposed in relation to client money.

Calculation of client money entitlements—the timing issue

CASS provides that, on the occurrence of a primary pooling event, client money in each client money account is treated as pooled, and the firm (or its administrator) must distribute client money so that each client receives a sum which is "rateable to the client money entitlement" of that client.[42] The client money entitlement is calculated on the basis of both the client's individual money balance and also the client's "equity balance". The client's equity balance is the amount which the firm would be liable (ignoring any non-cash collateral held) to pay to a client (or the client to the firm) in respect of any margined transactions if each of the client's open positions was liquidated. If there is a positive balance in relation to the client's contribution to the client money pool and a negative client equity balance, the latter is deducted from the former to arrive at the client's client money entitlement, and if there is a negative balance in relation to the client's contribution to the client money pool (i.e. money is actually owed by the client) and a positive client equity balance, the sum owed by the client is deducted from the client equity balance.[43]

In the *Lehman Brothers* case, Briggs J. held that the client money entitlement is determined at the time of onset of administration or the "primary pooling event", as opposed to at a later time (such as when any margined transactions are closed out and any profit or loss crystallised).[44] This point was not appealed. The requirement to take into account the client's equity balance in relation to margined transactions when calculating the client money entitlement leads to an intractable timing problem. If the client money entitlement is calculated at the date of the primary pooling event, the client equity balance will not have crystallised at that time as the margined transactions maintained on behalf of a client (for example, with a clearing house) will continue

[37] The FSA proposes to prevent the use of title transfer collateral in the retail context. This note is concerned with the wholesale markets and professional investors.
[38] Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003/3226).
[39] CASS 6.1.6R and 7.2.3R.
[40] Unless the financial institution has entered into the transaction as a market maker.
[41] Although no sum may be due from either party to the other.
[42] CASS 7A.2.4R.
[43] CASS 7A.2.5R.
[44] *Lehman Brothers* [2009] EWHC 3228 (Ch) at [324].

to exist until closed out in accordance with the agreement between the firm and its counterparty (which may be the rules of the clearing house, if the clearing house is the counterparty). The client equity balance is, therefore, a notional value, as opposed to a cash amount, based on prices prevailing on the date of the primary pooling event, and is for that reason liable to fluctuate in value subsequent to the date of calculation of the client money entitlement. The entitlements which are determined at the date of the primary pooling event are then applied to the client money pool as at the date of distribution (which will include any sums received from clearing houses and intermediate brokers from the close-out of margined transactions). It should be noted that the calculation of client money entitlements at the date of the primary pooling event may result in the total client claims being less than 100 per cent of the value of the client money pool at the date of the primary pooling event. In such an event, the remainder will constitute the firm's interests in the client money pool and will attach to the client money pool at the date of distribution.

The calculation of the client money entitlement at the date of the primary pooling event, taking into account the client equity balance, is therefore problematic for margined transactions, especially those with clearing houses. Clearing houses will typically have default procedures for dealing with member defaults, including defaults that constitute primary pooling events. Pursuant to Pt 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.[45] Under the default rules of clearing houses, open contracts of a defaulter (including client account contracts) may be closed out or transferred over a period of time. There is then an accounting for losses and gains, and a calculation of an amount due in respect of client 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 in relation to each of its client account and its house account. Collateral held in relation to an account is then applied if a net sum is due from the clearing member on that account. It is therefore problematic to take into account any equity balance existing at the time of the primary pooling event, given that the positions representing this balance will subsequently fluctuate in value and may, by the time the clearing house has completed the close-out process and determined a net sum, have either increased or decreased in value.[46]

All clearing houses in the United Kingdom allow for the transfer of client contracts to solvent clearing members. If a client has a positive equity balance under contracts with a clearing house and "ports" all of its contracts and margin it will get a free windfall from the client money pool, due to its interest already having been crystallised and fixed as at the primary pooling event.

The better solution would be to treat margined transactions separately and not to take into account any equity balances in calculating a client's share of the client money pool. Entitlements of clients in these cases should be based on close-out values and should take into account any "porting". This would complement the proposal suggested above to impose a statutory trust so that clients have a beneficial interest in any receivables arising from margined transactions that are attributable to their transactions with a firm or clearing member. The receivable and any proceeds thereof would, following the onset of insolvency, continue to be held on trust and would be returned to clients following the calculation of their entitlements under their individual transactions with the firm or clearing member.

Different capacities and clearing

Under Pt VII of the Companies Act 1989, actions taken by a recognised clearing house under its "default rules" are subject to various protections from insolvency claw-back and the moratorium applicable on an administration or insolvency. The term "default rule" is defined in s.188 of the Companies Act 1989 as:

> "[R]ules of … a recognised clearing house which provide for the taking of action in the event of a person appearing to be unable, or likely to be unable, to meet his obligations in respect of one or more market contracts connected with the … clearing house."

The term "market contract" is in turn defined in s.155(3) of the Companies Act 1989 (as amended pursuant to the Financial Markets and Insolvency Regulations 2009) as including:

> "[C]ontracts entered into by the clearing house, in its capacity as such, with a member of the clearing house … for the purpose of enabling the rights and liabilities of that member … under a transaction to be settled."

Pursuant to s.163 of the Companies Act 1989, the final stage of any default proceedings of the clearing house is to declare a "net sum" as due to or from the defaulting clearing member. Section 187 of the Companies Act 1989 provides that a clearing house is required to conduct its default proceedings "as if the contracts were entered into by different persons" where a clearing member enters into market contracts in a "different capacity". As a result, separate "net sums" would need to be declared in respect of each pool of contracts and related margin in respect of which the clearing member acts in a "different capacity". This provision is intended to prevent a clearing house

[45] The terms of clearing house default rules are largely prescribed by paras 21–24 of the Schedule to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (SI 2001/995).
[46] The net sum is also of probative value in insolvency proceedings under s.163 of the Companies Act 1989.

treating proprietary positions and collateral of a clearing member as capable of being set off against or combined with positions and collateral relating to a clearing member's customers.

Under reg.16(1)(a)(i) of the Financial Markets and Insolvency Regulations 1991 (as amended by the Financial Markets and Insolvency Regulations 2009), a clearing member is deemed to be acting in a different "capacity" for purposes of s.187 Companies Act 1989 if "money received by the member … is … clients' money for purposes of rules relating to clients' money". The definition of "rules relating to client money" (in reg.16(1D)) refers to rules made by the FSA under ss.138 or 139 of the FSMA. These rules are set out in CASS. In consequence, where a clearing member provides money that was client money to a clearing house as collateral, the clearing member is deemed to enter into contracts with the clearing house in a different capacity.

As a result of these provisions it is clear that collateral which was previously client money received by a clearing house may be segregated from the collateral provided by a clearing member in respect of its proprietary business. However, many clearing members conduct customer clearing activities on a riskless principal basis following receipt of title transfer collateral. Furthermore, many clearing members are banks who take cash collateral on their own balance sheet and not as client money. It is unclear how such persons could be acting in a "different capacity" given that they act in the same capacity (i.e. as principal, providing their own funds) for both proprietary and customer transactions.

Separately, some clearing houses in the United Kingdom have started to seek to allow clearing members to offer different sorts of customer accounts, some referring only to a single customer or groups of customers or in relation to particular cleared products. Again, it is difficult to reconcile such approaches with the strict wording of s.187 of the Companies Act 1989 unless a very broad view is taken of the meaning of the term "capacity".

New secondary legislation is needed under s.187 of the Companies Act 1989 in order to provide that clearing members that enter into market contracts on a riskless principal basis and provide non-client money to clearing houses act in a different "capacity" to prevent such collateral and contracts from being co-mingled with house account trades and collateral. In addition, where customers' transactions and collateral are recorded in different customer accounts at the clearing house, then the clearing member should be treated as acting in a different capacity in respect of each account.

Existing proposals for reform

HM Treasury has published proposals for a new regime for investment bank resolution, including specific proposals for strengthening the client asset protection regime.[47] The key proposal is a special administration regime for investment firms, including the imposition of a number of special objectives on the administrator of an investment firm. The first objective would be to ensure the return of client assets as soon as reasonably practicable. The administrator would have the power to set a bar date for the submission of claims to beneficial ownership of client assets or claims of persons in relation to a security interest asserted over those assets. Prior to making a distribution of client assets, the administrator would seek the approval of the court.

In addition, the FSA has published the following proposals for consultation[48]:

(a) introducing a disclosure annex for prime brokerage agreements, where any contractual re-hypothecation provisions are summarised, including a statement setting out the risk to the client upon the prime broker's default. The annex itself will not have any legal effect, although firms will have to ensure that it is clear, fair and not misleading;

(b) introducing a requirement that prime brokers offer daily reporting to all clients;

(c) restricting the placement of client money deposits held in client bank accounts within a group, so that intra-group client money deposits are restricted to 20 per cent of the firm's total client money held in client bank accounts;

(d) prohibiting the use of general liens in custodian agreements;

(e) establishing a CASS oversight controlled function. The person tasked with the Client Assets Oversight Function will have responsibility for ensuring a firm's compliance with the CASS provisions on client assets and money; and

(f) reintroducing a client money and assets return (the CMAR). The CMAR will be reviewed and authorised by the person holding the newly established CASS oversight function on a monthly basis for medium and large firms and bi-annually for small firms.

The Government's and FSA's proposals do not go so far as to amend insolvency law as it applies to investment banks. They do not amend the current ranking of the claims of clients with proprietary entitlements[49] vis-à-vis those of general creditors. None of the Government's

[47] We understand that HM Treasury will no longer pursue the proposal of establishing a new client asset trustee office to exist alongside the administrator.
[48] See FSA Consultation Paper: *Enhancing the Client Assets Sourcebook* (FSA, 2010), CP 10/9, at *http://www.fsa.gov.uk/pubs/cp/cp10_09.pdf* [Accessed October 8, 2010].
[49] Including those who have lost their proprietary rights as a result of a failure by the financial institution to comply with its regulatory duties.

proposals would affect the treatment of clients whose proprietary entitlements have been diminished or extinguished or where there is a shortfall in the client money pool due to a firm's breach of regulatory or fiduciary duty. Clients with diminished or extinguished proprietary entitlements or clients facing a shortfall in the client money pool would continue to remain general creditors in respect of such entitlements or shortfall. The FSA's approach recently has been to take enforcement action against non-compliant firms and launch investigations into client money procedures at firms, to encourage compliance.[50]

Suggestions for reform

It is unlikely to be possible to achieve protections that properly match client expectations through regulatory rules alone. There are two changes to the law that merit particular consideration. The first would involve an amendment to insolvency laws to give explicit priority to clients where they have a reasonable expectation that their assets are held on trust and therefore ring-fenced from the insolvency estate including in respect of any shortfall in the client money pool. The second is to consider some form of statutory "floating trust" or charge that affects a broader class of the assets of a financial institution that has breached CASS, so as to ensure clients are placed ahead of general creditors on an insolvency and that a broader class of assets fall outside the insolvent estate.

Amending the insolvency regime

If the principle that clients should rank ahead of general creditors is accepted, then it could be implemented by amending insolvency law as it applies to financial institutions, starting with investment firms. Broader amendments could be considered for non-financial companies if thought appropriate.

Section 233 of the Banking Act 2009 enables HM Treasury to adopt investment bank insolvency regulations for the purpose of modifying the law of insolvency as it applies to investment banks and establishing a new insolvency procedure for investment banks.[51] However, this power must be exercised within two years of the enactment of the Banking Act 2009 (i.e. by February 12, 2011).[52]

New regulations could include provisions that deal with the creation or enforcement of rights (including rights that take preference over creditors' rights) in respect of client assets or other assets.[53] The term "client assets" is defined, for the purposes of these provisions, as "assets which an institution has undertaken to hold for a client (whether or not on trust and whether or not the undertaking has been complied with)".[54] The Treasury's powers therefore extend beyond client assets actually held on trust for clients and can make provision for assets that ought to have been held on trust but which have been misapplied or dissipated.

Accordingly, the insolvency regime for investment firms (including the Insolvency Act 1986) could be amended to achieve the result that:

(a) in the event of an investment firm's insolvency, the insolvency officer is under a duty to determine the client assets actually held *or that ought to have been held by the firm*, as well as the claimants of such assets;

(b) the insolvency officer further determines whether there is any shortfall in the client money pool at the date of distribution thereof;

(c) once these determinations have been made, the officer is under a duty to return these assets and monies to their claimants (including by making payment of sums to claimants who have lost their proprietary rights as well as making good any shortfall in the client money pool) as soon as practicable and, in any event, prior to the commencement of liquidation; and

(d) such distributions are made prior to distributions to general creditors.

This regime would give priority to clients so that they rank ahead of the general creditors, irrespective of whether the clients have lost any proprietary rights and whether there is any shortfall in the client money pool. It would also enshrine procedures that are intended to facilitate the rapid pay-out of the claims of clients prior to the commencement of liquidation in a similar fashion to the new "bank insolvency procedure" set out in the Banking Act 2009 which requires rapid pay-out of monies to all protected depositors of a bank in the event of its insolvency. So long as clients could obtain an up-to-date "screen shot" of their entitlements (which is something they could be required to be provided by firms on an ongoing basis as a regulatory matter) they would be in a position to present to the insolvency officer a document which could be treated as a presumptively correct statement of their priority entitlements and they could be given the relevant assets and monies promptly and without dispute.

The advantages of such an approach, including advantages over the trust approach discussed below, are that it would:

[50] J.P. Morgan Securities Ltd was fined a record £33.22 million.

[51] "Investment bank", for the purposes of s.233, is defined as an institution that has permission to carry out the regulated activity of safeguarding and administering investments, dealing in investments as principal, or dealing in investments as agent, which holds client assets and which is incorporated in, or formed under the law of any part of, the UK: Banking Act 2009 s.232.

[52] Banking Act 2009 s.235(4).

[53] Banking Act 2009 s.234(6).

[54] Banking Act 2009 s.232(4).

(a) achieve priority for clients over general creditors by amending the order of priority prescribed by insolvency law rather than imposing a trust or charge on all of the investment bank's assets. This avoids any conceptual, operational or liability difficulties that may arise where all the assets of a firm are affected by a trust;

(b) impose duties on insolvency officers and special procedures to ensure the rapid pay-out of clients' claims. This may be more difficult to achieve using the floating trust or charge concept;

(c) not confine its protections to those clients who intended their assets to be held upon trust but would extend to all clients having a legitimate expectation that specific assets would be held for them by the investment firm. Hence, it would be consistent with the Government's proposals for reform of the client assets and money regime;

(d) treat all clients equally, irrespective of whether any of them has suffered the misfortune of losing their proprietary entitlements through no fault of their own but entirely by reason of the fortuitous circumstance of whether the financial institution has complied with its regulatory duties as regards a particular client; and

(e) reflect a similar scheme which is already in place for payment institutions regulated under the Payment Services Regulations 2009.[55]

Statutory floating trust or charge

This alternative option envisages an amendment to s.139 of the FSMA so that the FSA[56] is given the power to impose an additional "floating" trust on all the assets held by a financial institution that has breached its regulatory or fiduciary duties in relation to client property and in favour of (i) those clients whose proprietary rights have been extinguished or diminished as a result of such a breach and (ii) the clients as a whole where there is a shortfall in the client money pool. The trust would be imposed in addition to the statutory trust that is imposed on client money accounts.

In the *Lehman Brothers* case, an argument was advanced that the trust imposed by the FSA under s.139 is a "floating trust" that applies to all the accounts and receivables of an investment firm. This argument was rejected by Briggs J.[57] on the grounds that what was being advanced was better characterised as a charge rather than a trust. The point was not appealed. However, a floating trust could be imposed by statute. Statute may impose a trust even if the statutory trust does not satisfy all the requirements that are ordinarily required by law for a trust to exist.[58]

The main features of this option are as follows:

(a) an additional statutory trust could be imposed in relation to all financial institutions (including, possibly, banks) that have breached their regulatory or fiduciary duties in relation to client property whereby the institution would hold all its assets upon trust for a certain class of beneficiary to be defined in the rules and for itself, with the beneficiaries accorded priority over the firm. The firm as trustee would be subject to a very circumscribed set of trustee duties prescribed by FSA rules so as to avoid liability issues for the general management of the firm[59];

(b) the class of beneficiaries would be those clients of the financial institution who provided assets or money to the institution or where the institution received assets or money on the basis that the clients would obtain proprietary rights in them, but where the proprietary rights have been extinguished or diminished as a result of a breach by the firm of its regulatory or fiduciary duties. This should include clients who have suffered a shortfall in the client money pool. The value of a beneficiary's interest would be equal to the extent to which its proprietary rights have been extinguished or diminished as a result of the institution's breach of any regulatory or fiduciary duties;

(c) the trust would not affect the validity of any dispositions of assets or any other dealings by the firm with third parties. These would be specifically protected by the legislation creating the trust;

(d) in the event of an insolvency of the institution, the trust beneficiaries would have proprietary rights in relation to all of the assets of the institution and these rights would be extinguished once their claims are satisfied. The beneficiaries would thus rank ahead of the institution's general creditors but behind any secured creditors, clients with beneficial interests in specific assets or monies, and retail depositors;

[55] Payment Services Regulations 2009 (SI 2009/209).
[56] Or its successor authority.
[57] *Lehman Brothers* [2009] EWHC 3228 (Ch) at [170].
[58] *Ahmed & Co, Re* [2006] EWHC 480 (Ch) at [111]–[113].
[59] In particular, rules could exempt firms from any onerous duties imposed by trustee legislation such as the Trustee Act 2000.

(e) it could be clarified in the legislation that the floating nature of the trust would not make it a charge.[60] There is nothing unusual about a trustee holding a certain fund of property on trust for itself and a class of beneficiaries. The fact that the trustee shares in beneficial ownership is not fatal to the existence of a trust. In addition, that a trustee is permitted to dispose of the trust property or replace it with other assets or indeed encumber the assets from time to time subject to the terms of the trust is not inconsistent with the existence of a trust; and

(f) in the event of insolvency, having satisfied the claims of any secured creditors, returned assets and monies to clients with specific proprietary rights and facilitated pay-out to retail depositors, the insolvency officer would be under an obligation to realise assets of the insolvent institution's estate in order to satisfy beneficiaries' claims, before paying any other creditors.

Other proposals

Apart from the two main options discussed above, there are other shortcomings in the current regime that could be addressed in a new CASS sourcebook and in some cases by specific legislative measures, including the following:

(a) the current rules could be changed so that client money in designated client accounts is returned promptly to the clients interested in those accounts and is not pooled with client monies in other client accounts;

(b) a new set of rules on client assets could include provisions on rehypothecation and re-use of client assets. One possibility is to provide that, even where a right of re-use has been exercised, a trust relationship exists in relation to any replacement assets as soon as identifiable, unless the agreement between the firm and the client explicitly provides that the client has a mere contractual right of return;

(c) rules could be framed in relation to receivables held by a firm that are referable to transactions undertaken on a principal basis on behalf of clients. A statutory trust could be imposed similar to that imposed under s.139 of the FSMA;

(d) consideration needs to be given to whether any costs of distributing client assets and monies occasioned by a firm's regulatory breaches and other failures should be borne by the insolvent firm's estate rather than the clients;

(e) regulations should provide clarity on opt-outs from the regime, including the ability of financial institutions (whether as custodians or prime brokers) to deny trustee status and fiduciary obligations and the extent to which this is compatible with statuses arising as a matter of law. As stated above, the FSA is contemplating the introduction of mandatory annexes in prime brokerage agreements. However, a broader obligation on firms to notify clients of their position (i.e. whether clients are beneficiaries, and if so of what, or whether they have merely contractual rights of return) could be considered;

(f) there is some uncertainty as to whether clients can pursue derivative actions against sub-custodians in order to leapfrog the custodian. This issue may be better addressed in the European Union's proposal to bring in pan-European legislation on securities holdings and dispositions but will need to be implemented in a way that assists clients in vindicating their property rights;

(g) where a financial institution undertakes a transaction on behalf of a client on a principal or riskless principal basis, the institution may open a transaction with a counterparty and fund the collateral required for such a transaction using its own monies or assets, before the client has actually transferred collateral to the institution. In this situation, there is some uncertainty as to whether the client should have any interest in the receivable arising from the institution's transaction with a counterparty prior to the transfer by the client of any collateral due to the institution. The better view is that the client should obtain a beneficial interest in the receivable on the basis that it has been given a loan by the institution to acquire it;

(h) many financial institutions have the ability to substitute one form of collateral provided by a client with another form of collateral. For example, some clearing houses will only accept cash and high grade investments such as G7 government securities, whilst a client may have provided collateral in another form (such as corporate bonds). This process, known as collateral transformation, entails the conversion of assets from one form to

[60] Even if it is characterised as a charge, legislation can exempt any statutory charge or lien from registration requirements or other formalities.

another by the financial institution. In addition, the financial institution may substitute one set of assets for another pursuant to an investment management mandate so as to maximise returns on the clients' assets. To the extent collateral has been provided by way of a security arrangement, the current provisions of CASS do not make explicit provision for the tracing of client assets into transformed collateral types. Collateral transformation may take place pursuant to rights of rehypothecation, potentially destroying the client's interest in the collateral. Various issues flow from collateral transformation, for example in relation to the valuation of returns on assets posted by the client and the close-out value of assets on a default. Many agreements do not deal with these adequately and the client asset rules make inadequate provision for fair outcomes;

(i) most clearing houses have the ability, pursuant to their default rules, to "port" the client contracts of an insolvent financial institution to a solvent financial institution. Whilst such action is clearly allowed, there is currently no explicit statutory basis for clearing houses to port the related "client-to-financial institution" contracts nor the associated collateral that has ultimately been posted by clients. It is currently being proposed by HM Treasury that clearing house default rules should also have insolvency protections in relation to these aspects, but it is unclear if and when legislation will be forthcoming in this respect. In addition, there is currently no international or pan-European recognition of the default rules of clearing houses[61];

(j) further consideration needs to be given to the timing of calculation of client money entitlements, particularly those held with clearing houses. In such instances, entitlements of clients to the client money pool should be based on the amounts and elements of the "net sum" calculation, rather than fixed at the time of insolvency or administration, so as to avoid unfair windfalls to "ported" clients;

(k) the position in the clearing context surrounding the ability to calculate separate net sums for client assets needs to be clarified. In particular, it should be clarified in para.16 of the Financial Markets and Insolvency Regulations 1991 that banks and persons who receive title transfer collateral from clients also act in a separate "capacity" for purposes of s.187 of the Companies Act 1989 so as to allow a clearing house to segregate such "client" margin and transactions from assets relating to the firm's proprietary trading activities. Also, a clearing member should be allowed to act in various separate capacities for different clients or groups of clients; and

(l) it should be considered whether additional protections could be imposed where banks hold client moneys on their own balance sheets, to level the playing field between those institutions and investment firms.

Conclusion

Whatever scheme is adopted, it should not interfere with market operations, market practices, general liability in the ordinary course of business or standard documentation, and should, above all, permit opt-outs provided the financial institution has clearly and properly informed the client of the consequences of the opt-out.

Non-custodian firms should be able to retain client assets and monies to satisfy obligations of the client to the firm where they have taken security over them. If clients are provided with regular reporting of their entitlements, which includes an indication of the level of security and what it covers, and this is given a presumptively correct status, it should be possible for clients to present a copy of the last such report prior to insolvency to the insolvency official so that they know which assets belong to the client and are to be returned immediately, and which belong ultimately to the firm and are to be retained.

The purpose of any reforms to the CASS regime and general law should be to strengthen the protections that are afforded to clients, in order to inspire greater confidence among the world's investor community in the United Kingdom as a financial centre and to improve the ability of financial institutions in the United Kingdom to attract financial flows and attendant business from investors around the world.

[61] The Settlement Finality Directive (98/26) deals with the treatment of in-flight payments and some in-flight securities settlement transactions but does not allow action to be taken in relation to open derivatives contracts. The proposed European Markets Infrastructure Regulation may deal with the point at a European level, though the position is currently uncertain.