

Insight: Banking

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The problem of “identification” – CASS7 and Lehman Brothers International (Europe) (In Administration) v CRC Credit Fund Limited & Others [2010] EWCA Civ 917

In the recent decision *Lehman Brothers International (Europe) (In Administration) v CRC Credit Fund Limited & Others [2010] EWCA Civ 917*, the Court of Appeal considered the ownership attaching to client funds held by Lehman Brothers International (Europe) (“LBIE”) following the decision of Briggs J in *Lehman Brothers International (Europe) v CRC Credit Fund & Ors* [2009] EWHC 3228 (Ch).

At the centre of the decision was the determination of the point in time when the statutory trust imposed by Chapter 7 of the Client Asset Sourcebook (known as “CASS7”) arose.

The facts arising out of the administration of LBIE most relevant to the judgment were simply that LBIE operated an “alternative approach” pursuant to CASS7 which meant client money when received by LBIE was not paid directly into segregated client accounts but rather paid into and held by LBIE in its account(s). Such monies were only segregated into client accounts at the end of each day following account reconciliations required as at the close of the previous business day. There were various discrepancies relating to LBIE’s movement of client money, resulting in both the over-segregation and under-segregation of client monies.

The Court of Appeal considered the following issues:

1. whether a statutory trust arose on receipt by LBIE of client money or only upon segregation;
2. whether CASS7 provides for the pooling of client money wherever found or only segregated client money;
3. whether clients should participate in the client money pool (“CMP”) if they have claims to client money or only if they have contributed to the pool; and
4. when does client money which the firm owes to a client become “client money”?

Whether a statutory trust arose on receipt by LBIE of client money or only upon segregation

It was held that CASS7 created a trust upon receipt by a firm of client money and that references in the CASS7 language to receiving and holding client money was to ensure that a statutory trust applies to both money which has been received and to money which is held by the firm.



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Whether CASS7 provides for the pooling of client money wherever found or only segregated client money

Arden J concluded that various elements of CASS7 and the overarching MiFID requirement to safeguard the rights of clients clearly supported the view that a single trust is created and a single pooling event occurred across all accounts containing “identifiable” client money and not just client money held in segregated accounts (i.e. the client bank accounts and client transaction accounts), thus creating a CMP. The Financial Services Authority (“FSA”) made submissions in support of this interpretation.

It was also determined by Arden J that there was, “limited value” in any argument that the interpretation that pooling applied to all client money, including “identifiable” client money outside of the segregated accounts would lead to delays in distribution of client funds which was inconsistent with the MiFID requirements underpinning CASS7.

The judgment did not deal in any substantive manner as to how the general trust law rules of tracing would apply other than to acknowledge that such general rules would supplement but not replace the statutory trust created pursuant to CASS7.

Whether clients should participate in the CMP if they have claims to client money or only if they have contributed to the pool

The Court of Appeal held that all clients whose monies are pooled must share in the CMP. This means that any client having a contractual right to share should so share, not just those clients with a proprietary right.

This conclusion rejected Briggs J’s proposition that the only persons entitled to share in the CMP were those clients

whose monies had indeed been segregated. Clients whose funds were held in LBIE’s own accounts had only general law remedies available to them.

When does client money which the firm owes to a client become “client money”?

Arden J determined that money which became due and payable by the firm and therefore money which the firm became obliged to (but at the relevant time did not) segregate in accordance with CASS7 was not “client money” and therefore did not form part of the CMP.

Client Money - Moving Forward

This judgment has been handed down following heightened enforcement activity in 2010 by the FSA in its monitoring of firms’ client money protections. In May and June respectively, the FSA fined Rowan Dartington & Co. Limited £511,000 and Close Investments Limited £98,000 for failing to properly protect and segregate client money. However, the more significant fine was the £33.32 million given to JP Morgan Securities Ltd in June 2010, for its failure to segregate client monies over a seven year period.

CASS7 is intended to protect client money by keeping it separate from a firm’s money, by ensuring that a firm has no “rights of use” in respect of such client money and facilitating the distribution of client money in a timely fashion. The judgment does address what the Court of Appeal saw to be a fundamental failing in the judgment of Briggs J, that the pooling which represents a high level of protection for client monies than that available under the general law should be achieved regardless of any failures by the firm to effect physical segregation of client monies. The judgment is however open to the contention that the key client protections sought to be promoted by the

application of CASS7 are undermined by the scope of CMP which requires client money to be “identified” (i.e. traced) in non-segregated accounts and the timing implications that such tracing mechanics will entail. Although the Court of Appeal did not agree that its approach to pooling would introduce timing delays into the CASS7 process, this was obviously a concern for the Administrator’s on whose behalf it was submitted that it should not be incumbent on the Administrators to identify client money outside the segregated accounts unless they had been put on enquiry, whether by the firm’s records or by a sufficiently supported claim, that specified money was client money. The Court of Appeal did not however make a determination on this issue but rather left this matter to be the subject of directions to be given by the Companies Court of Appeal.

The scope of implications of this judgment for financial services firms is not quite known. What is known is that those firms which currently operate under the “alternative approach” in CASS7 will need to understand better the “identification” of client monies in firm accounts, in particular, the role the books and records of a firm will play in such identification and also how client money is to be received and segregated following receipt will need to be considered. For the time being however, any further movements towards a further appeal or indeed by the FSA in its role as regulator will need to be monitored before the true implications of this judgment are clear.

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