

Insight: Regulatory

March 2012

UK Supreme Court Rules in Favour of Unsegregated Clients in Lehman Brothers International (Europe) (In Administration)

PwC, the administrators in the Lehman Brothers administration in the UK, have made several applications to the Court seeking directions on their approach to the distribution of clients' money and assets. On 29 February 2012 the Supreme Court gave judgment on issues that are central to the interpretation and application of the rules for the protection of client money made by the Financial Services Authority. The issues raised are ones that have divided judicial opinion. The Supreme Court by a majority of 3 to 2 upheld the decision of the previous appellate court and disagreed with the rulings of Briggs J, the judge assigned to the Lehman administration. The court process, that has taken nearly three years to complete, may yet require further applications in order to obtain clarity on the precise directions that the administrators should follow.

Now that the UK's highest court has given its ruling the FSA might presumably take steps to review the rules that have generated such uncertainty. The FSA may, as part of such review, undertake a more root and branch examination of the policy which underpins the rules. This could result in less extensive protection for clients but with the benefit of potentially faster payouts where firms fail.

For customers one of the key lessons is the need to understand whether and if so to what extent their money is protected when it is held by an investment firm and to appreciate the options that may be available to them to achieve the best outcome, recognising that complete safety and protection is likely to be impossible. Even customers that are very careful to monitor that their money has been properly segregated by a firm could find that in the event of the firm's default, their claim for the return of client money will be diluted as a result of client money claims against the firm by persons whose client money should have been segregated, but which was not.

Currently there is no clear way around this problem, unless customers were to seek to appoint third parties as custodian for any assets transferred – although this may not be a practical solution in many cases.

In the event of nil or partial recovery, customers who are eligible may be able to make a claim under the Financial Services Compensation Scheme, up to £50,000. One potential option open to the FSA as a result of its review of the CASS rules would be to introduce a broader compensation scheme for client assets, analogous to the Securities Investor Protection Corporation ("SIPC") scheme in the United States. However, this would represent a significant departure from previous policy in this area, and there is no indication at present as to the direction the FSA will take in its review.



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Background

The appeal concerned the interpretation and application of 'client money rules' and 'client money distribution rules' under Chapter 7 of the FSA's Client Assets Sourcebook ("CASS 7"). CASS 7 implements certain requirements of the Markets in Financial Instruments Directive 2004/39/EC ("MiFID").

CASS 7 contains no express provisions dealing with the circumstances where a firm has failed to comply with its obligations in relation to client money. In the judgment, Lord Walker observed that Lehman's had failed to comply with its obligations in relation to client money "on a truly spectacular scale," and noted that "neither in the Directive nor in CASS 7 is there any indication of what is to happen if the organisational requirements are not complied with, and clients' money is not segregated as it should be."

A primary pooling event ("PPE") occurs when an authorised firm holding client money enters the insolvency process. In this event, the CASS 7 rules require client money held by the firm to be ringfenced from the firm's assets and pooled to be distributed to those entitled to it.

The fundamental questions addressed by the Supreme Court were:

- i. When does the statutory trust created by CASS 7.7.2R arise;
- ii. Do primary pooling event requirements apply in relation to client money held in house accounts (i.e. does client money held in house accounts form part of the client money pool ("CMP"); and
- iii. Is participation by a client in a distribution from the CMP dependent on a client's money having actually been segregated and held within a firm's client money trust account.

Executive Summary

- i. The statutory trust under CASS 7, facilitated by s.139 of the Financial Services and Markets Act, arises **on receipt** of client money by the firm;
- ii. Primary pooling event requirements **do** apply to client money held in house accounts – and therefore such client money, if identifiable, forms part of the CMP; and
- iii. A client's participation in the client money pool is **not dependent** on the client's money having actually been segregated in the firm's trust account.

Case Analysis

i. When does the statutory trust created by CASS 7.7.2R arise?

The fundamental principle behind CASS 7 is the segregation of client money from a firm's own money in order to safeguard client money in the event of the firm's insolvency. CASS 7 operates through a combination of segregation and the imposition of a statutory trust. The question is whether the statutory trust is dependent on segregation for its formation.

The Supreme Court Justices unanimously agreed that the statutory trust arises **on receipt** of money by the firm as opposed to the time at which it is segregated. The ratio being that it would be contrary to the purpose of client protection under MiFID if on receipt of money it ceased to be the client's and only became the client's property again once it was segregated by the firm. Protection would be arbitrary and dependent on the firm's own practice: the greater the level of incompetence (or misconduct) of the firm, the lesser the protection for clients.

In addition, the Supreme Court Justices deemed the language of CASS 7.7.2R sufficiently clear on this point to establish that the statutory trust arises on receipt.

ii. Do primary pooling event requirements apply in relation to client money held in house accounts?

Under CASS 7 there are two possible interpretations of whether client money in house accounts should be pooled. The majority of the court took the view that where there are two possible interpretations, weight should be given to the wider policy behind CASS 7, which is to afford a high level of protection to all clients. Accordingly, primary pooling arrangements do apply to client money held in house accounts to the extent that such money is **identifiable** as client money.

As Lord Dyson and Lord Clarke emphasise, "to exclude identifiable money in house accounts from the distribution regime runs counter to the policy underlying CASS, which is to provide a high degree of protection to *all* clients in respect of money in *each* money account of the firm." (Lord Dyson's emphasis). This reasoning highlights the purposive approach of the court.

Nonetheless, this gives rise to the further issue of what constitutes "identifiable" client money? What are the limits to such identification? This will be a particularly difficult question to address as CASS is not bound to follow the ordinary rules of trust law. Without further direction from the court, it is not at all clear how the process of identification will work.

iii. Is participation by a client in a distribution from the client money pool dependent on a client's money having been segregated and held within a firm's client money trust account?

The majority rejected the "contributions" approach. Lord Dyson stresses that the language of CASS 7.7.2R "points to the beneficiaries under the distribution rules as being all the clients for whom the firm has received and is holding client money." Moreover, he emphasises the court's purposive approach stating "it is necessary to stand back from the detail and ask which

interpretation better promotes the purpose of CASS 7... a purposive interpretation clearly supports the claims basis for participation." As a result, where a client had a contractual entitlement for his money to be segregated, he will be entitled to participate in the CMP, even though his money was not in fact segregated and does not form part of the CMP. One impact of this would therefore be to dilute the pro-rata share of segregated clients in the CMP in favour of clients whose client money was un-segregated.

Dissenting Judgments

Lord Hope and Lord Walker dissented on the second and third issue.

Lord Walker was uncomfortable with what he termed "a cataclysmic shift of beneficial interest on the PPE, to the detriment of those clients who must have supposed that their funds were safely aggregated in accordance with CASS 7.1-7.8." Lord Walker also dismissed as "unrealistic" the notion that clients of the firm implicitly accepted the risk of discovering, on a PPE, that their segregated funds would be shared with non-segregated clients.

Lord Walker found the concept of a "single trust" for the benefit of all clients unconvincing support for the "claims basis" and rejected a purposive reading of CASS 7 as the CASS rules did not provide for failures to segregate as spectacular as in this instance.

Lord Hope was also unconvinced by the "single trust" argument holding that the client money pool consists of the aggregate of the segregated funds holding clients' money immediately before the primary pooling event. Moreover, he contends that the relationship is a fiduciary one which would protect clients' money until all obligations to them are discharged and thus the claims basis is incompatible.

Impact of the Case

- The complexities of the case and the implications of the judgment mean that the Special Administrators may well have to return to the first instance court, to which the Lehman administration is assigned, for further directions. Until such directions are received, the full implications will not be clear.
- The Special Administrators for MF Global have commented that the decision means that the distribution of MF Global's assets will likely take longer as they will need to:
 - conduct a detailed and thorough regulatory and legal analysis of each client's position, to establish if they may have a contractual entitlement to client money and so should have a segregated client money claim: the result of this analysis is likely to increase the number of claimants to the client money pool and so dilute the distribution between them; and
 - conduct a forensic analysis into MF Global UK's own bank accounts and potentially extend this to other assets acquired by the firm using funds from those accounts: the result of this analysis may increase the size of the client money pool and as a consequence there may be a decrease in the size of the general asset pool available for unsecured creditors which may, however, be compensated to some extent by the decrease in number of the unsecured creditors.
- The Supreme Court Justices identified a limitation in the scope of CASS (and by the same token the Directive) and in particular CASS 7. Thus, it seems likely that there will be a review of the CASS rules.

Further Questions

The Supreme Court decision leaves a number of unanswered questions that may need to be the subject of a further application to the Court:

For example, there is an unanswered question in relation to Final Reconciliation – specifically, how is money that moves between the point of last segregation ("PLS") and the Primary Pooling Event ("PPE") to be treated?

Lord Hope and Lord Walker took the position that the administrators should reconcile between the PLS and the PPE. However, Lord Clark and Lord Dyson were of the view that the administrators should reconcile, but it should not be limited to the period between the PLS and PPE. This begs the questions, what are the limits to reconciliation? How far back do the administrators go?

Glossary

Primary Pooling Event ("PPE")

In this case, it was the moment that Lehman Brothers International (Europe) went in to administration at 7.56 BST on Monday 15 September 2008.

Client Money Pool ("CMP")

This is the pool of segregated client money funds from which client money entitlements are paid after a primary pooling event occurs.

Point of Last Segregation ("PLS")

This was the last point, before the PPE, at which client money was segregated. In this case it was Friday 12 September 2008, reflecting the position at close of business on Thursday 11 September 2008.

The 'Claims Basis'

The argument that all clients who have a contractual entitlement to have their money segregated as client money are entitled to participate in payments from the client money pool after a primary pooling event, whether or not their funds were segregated.

The 'Contributions Basis'

The argument that only those clients who have had their client money actually segregated into a client trust account and, consequently, have contributed to the client money pool, are entitled to participate in payments from the client money pool.

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