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Analysis of legal uncertainty in the Financial Services Authority's Client Assets Sourcebook and arising from judicial decisions relating to the administration of Lehman Brothers International (Europe)

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INTRODUCTION

Context

1. The 2008 financial crisis has exposed various uncertainties regarding the holding of client monies by investment firms. In particular, the High Court's decision in *Lehman Brothers International (Europe) v CRC Credit Fund Limited and others* [2009] EWHC 3228 (Ch) and the decision of the Court of Appeal in *CRC Credit Fund Limited v GLG Investments Sub-Fund* [2010] EWCA Civ 917 (the "Lehman Case") have highlighted issues surrounding the nature and effect of the statutory trust created under Client Assets Sourcebook ("CASS") of the Financial Services Authority ("FSA") where an FSA authorised firm (a "Firm") fails to segregate properly the monies which it receives from a client.
2. The FMLC considers that these issues give rise to material legal uncertainty in the financial markets.
3. In response to the financial crisis, the FSA recently amended CASS. As the FSA indicates, during the consultation period it participated in the Court of Appeal hearing in the Lehman Case and gave careful consideration to ensure that the hearing would not adversely affect the policies proposed.[3] However, the FSA will only undertake a comprehensive review of the regime under CASS once the appeal to the Supreme Court in the Lehman Case has been decided in late 2011 or early 2012.
4. This FMLC has prepared this paper for the FSA in its consideration of CASS. In particular, the paper seeks to deal with:
    a. the uncertainties highlighted in the High Court's decision in *Lehman Brothers International (Europe) v CRC Credit Fund Limited* and the decision of the Court of Appeal in the Lehman Case surrounding the point at which the statutory trust created pursuant to CASS arises;
    b. the uncertainties regarding the nature of the assets and claims forming part of the statutory trust and the remedies available to the holders of the beneficial interests under the statutory trust where a Firm has failed to segregate monies in the client account; and
    c. some policy solutions for addressing uncertainties above, including the power to transfer unsegregated monies from the "house" account to the "client" account and the power to treat a claim for client monies as an expense of a Firm's administration in cases where the statutory trust and/or proprietary remedies fail.

[3] See FSA Policy Statement 10/16, p 6.

5. It is not within the FMLC's remit to comment on policy issues. However, the FMLC notes some of the possible options for addressing issues of legal uncertainty, particularly that identified in section 3 below, would have the effect of creating a type of client preference in the event of the administration of a Firm or some other similar proceeding. This would, of itself, require the FSA and/or HM Treasury to make a policy choice as to who should be entitled to claim or otherwise be the beneficiaries under such a regime. The FMLC also notes that, although this paper is directed in the first instance at issues surrounding the interpretation and application of CASS, the issues highlighted go beyond CASS and, more particularly, changes to the CASS regime.
6. By way of background, in preparing this paper, the FMLC notes the basic duties on a Firm to, inter alia:
   a. place promptly client money into one or more accounts opened with, inter alia, a BCD credit institution in terms of CASS 7.4.1 R;
   b. take the necessary steps to ensure that client money deposited, in accordance with CASS 7.4.1 R, is held in an account or accounts identified separately from any accounts used to hold money belonging to the firm;
   c. limit the funds that it deposits or holds with a relevant group entity or combination of such entities so that those funds do not at any point in time exceed 20 per cent of the balance on: (1) all of its general client bank accounts considered in aggregate; (2) each of its designated client bank accounts; and (3) each of its designated client fund accounts; and
   d. report to the FSA in relation to the identity of the entities with which it deposits client money and the amounts of client money deposited with them pursuant to Section 16.4 of the FSA Supervision Manual.
7. This paper sets out in Appendix One some suggested amendments to CASS for the FSA to consider. However, it will be noted that some of the policy options necessary to enhance the protections in CASS and address the uncertainties identified in this paper would involve the change to regimes outside the control of the FSA, in particular that under the Investment Bank Special Administration Regulations 2011 ("IBSAR").[4] In the context of the issues highlighted in this paper, enhancement of the client assets regime in CASS is not confined to changes to CASS alone.

[4] SI 245/2011.

SECTION 1 – CREATION OF THE STATUTORY TRUST

8. Section 139 of the Financial Services and Markets Act 2000 provides the statutory basis for the statutory trust in CASS 7.7.2 R.[5] Section 139 provides that: "Rules relating to the handling of money held by an authorised person in specified circumstances ('client money') may make provision which results in that client's money being held on trust in accordance with the rules". CASS 7.7.2 R gives effect to section 139 by providing that: "A Firm receives and holds client money as trustee".

9. Neither section 139 of FSMA nor CASS 7.7.2 R, however, sets out the attributes of the statutory trust. Although it is possible for FSA rules to provide for the application of the statutory trust, its use and the consequences of its use (or abuse), it is not possible for the rules to ignore the necessary attributes of the trusts as they are determined by the common law. In particular, the statutory trust must adhere to concepts such as certainty of objects and certainty of subject matter which apply to all trusts. Amongst other reasons for this constraint is the self-evident point that Parliament must have intended that the mechanism it was designing would be understood by English lawyers as established legal doctrine.

10. Moreover, in construing CASS 7.7.2 R, a court must give effect as much as possible to the scheme under MiFID which is concerned with the safeguarding of client assets and assumes that there is a risk that client assets may be lost and, more particularly, ensuring that client monies are not used by the firm for its own account.[6]

The Lehman Case

11. Lehman Brothers International (Europe) ("Lehman"), as the main UK trading subsidiary of Lehman Brothers Holdings Inc., held significant amounts of money as client money for and on behalf of its clients. On its insolvency on 15 September 2008, a "primary pooling event" within the meaning of CASS occurred. However, since the last reconciliation before the primary pooling event was performed on the morning of 12 September, some money that should have been credited to a client bank account remained in Lehman's own account. This failure to segregate was compounded by errors and discrepancies in earlier segregation exercises which Lehman had carried out. As CASS is silent as to how monies should be distributed in this scenario, Lehman's administrators applied to the High Court for directions.

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5 Formerly CASS 4.2.3R. CASS 7 replaced CASS 4 on 1 November 2007, when the Markets in Financial Instruments Directive (EC Directive 2004/39/EC) ("MiFID") came into effect.

6 See the judgment of Arden LJ in the *Lehman Case* at paragraph 62.

12. In the High Court, Mr Justice Briggs analysed the relevant provisions of CASS in light of the general law holding that:

    a. CASS 7 imposed a statutory trust on client monies as soon as they were received by Lehman;

    b. the rules provided for the pooling of client monies but only those which had been credited to segregated accounts;

    c. the only persons entitled to share in the client money pool were those clients whose funds had been placed in segregated accounts; and

    d. those clients with funds in Lehman's own accounts had to pursue processes available to them under the general law, such as tracing, otherwise they were general creditors of Lehman's estate.

13. On appeal, the Court of Appeal:

    a. agreeing with Mr Justice Briggs, held that Article 13(8) of MiFID required CASS 7 to provide for a trust of client monies with effect from the time of actual receipt. The trust was not, therefore, "deferred" until segregation was completed;

    b. disagreeing with Mr Justice Briggs, decided that the pool arising under CASS 7.9.6 R on the primary pooling event included not only segregated monies in segregated accounts but also all identifiable client money in Lehman's "house" accounts;

    c. disagreeing with Mr Justice Briggs, observed that it was "implicit in safeguarding the assets of clients that the clients should all share in the remaining assets" and held that the client money pool should be distributed to all clients according to what they were contractually entitled to have segregated for them as opposed to what was contributed by them to the pool; and

    d. agreeing with Mr Justice Briggs, held that client money did not include sums due and payable by the Firm to its clients, but not yet specifically appropriated for that purpose.

14. The Lehman Case has been appealed and will be heard by the Supreme Court on 31 October 2011. The FSA has indicated that it will review CASS 7 after the appeal to address the statutory trust issues.

Policy Options

15. Given the uncertainties which the Lehman Case highlights, consideration should be given to whether the specific attributes of this particular statutory trust should now be identified. In this respect, the most important aspect is that relating to the point at which the statutory trust arises.

16. P*rima facie* this should be capable of swift repair through a minor amendment or addition to CASS which would have the effect of favouring the clients of a Firm which had failed to place their monies in segregated accounts. However, as discussed in Section 2 below, the issue of the point at which a statutory trust arises also goes to the issue of the nature and scope of the rights which beneficiaries of the statutory trust can or should be permitted to enjoy. In considering any amendments to CASS, these issues need to be considered together.
17. There are three options for determining the point at which the statutory trust attaches:
    a. Option One - the point of segregation of client monies into an account in the client's or clients' name(s);
    b. Option Two - the point of receipt of client monies into a Firm's "house" account; and
    c. Option Three - the point of receipt into a Firm's general estate.
18. These options and their implications are considered below.

Option One - the Point of segregation

19. Option One would provide legal certainty.
20. However, Option One only provides protection for client monies in the event that Firms comply properly with FSA requirements, which the circumstances giving rise to the Lehman Case show is not always the case.
21. Where a Firm fails to segregate monies, a client will have no beneficial interest under a statutory trust and, in consequence, will suffer by receiving a lesser claim to the return of their funds (that of an unsecured creditor of the general estate). As a matter of policy, at least in the case that the failure to segregate prior to administration arises through negligence,[7] it is unfair that a client should suffer as a result.[8]
22. Moreover, this appears to be unnecessarily restrictive given the view of Megary J in *Re Kayford* [1975] 1 WLR 279 that a trust of money can be created without a stipulation for payment into a separate account.
23. A statutory right to recover any shortfall, as discussed in section 2 below, could help address the issue of a client suffering unfairly from a Firm's failure to comply with an FSA requirement. Save specifically for the suggested amendment to CASS 7.7.2 R in Annex One to this paper intended to give effect specifically to Option Two below, the suggested amendments as a whole could help remedy the shortcomings of Option One identified above.

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7 It is noted that failure to segregate may have occurred, as in the case of LBIE, on an intra-day basis, without negligence, as a result of the use of the alternative approach, where client money is segregated following close of business.

8 Against this is the argument that this is not unfair or any unfairness is sufficiently mitigated because the results of the Firm's negligence are shared equally by all the clients with segregated funds which are pooled and distributed under CASS 7A.

Option Two - the Point of receipt into the "house" account

24. Option Two is consistent with the finding in the Lehman Case and would help address the operational risk highlighted in the Lehman Case that a Firm might fail to transfer the monies received into a segregated account. It is also the FSA's preferred approach.
25. Option Two enables those who transfer client monies to a Firm's "house" account, held with and provided by a third party bank, to have an interest in that money notwithstanding that the Firm has failed to place it in a segregated account. The FSA could confer a right to claim against the trust (*i.e.* the sum of client monies in the "house" account held by the Firm at the point of insolvency) consistent with the Court of Appeal's findings in the Lehman Case. The FSA could remedy the above uncertainty by inserting an express provision to this effect into CASS.
26. Option Two would increase the likelihood that monies received by a Firm before its failure or which were in transit to the Firm could be treated as part of the client money pool available for distribution and be made available for distribution to clients rather than to be absorbed by the estate for wider distribution to general creditors.
27. The approach under Option Two is consistent with the common law position that it is possible for a trust to exist over a share of a "house" account in which client monies are mixed with the Firm's own funds.[9] Such a trust will not fail for want of certainty of object merely because the monies form part of a fungible mass which is beneficially shared with the trustee provided that the fungible mass itself is clearly defined.[10] Nor does it matter for these purposes if the "house" account is, in fact, a constantly fluctuating fund into which monies, being the subject of an entitlement by other counterparties of the Firm, are paid and then withdrawn.[11] Moreover, the mere fact that the Firm may not be contractually required to pay client monies into a separate account, or to ensure that they are received into such an account, does not prevent a common law trust arising and attaching to a mixed "house" fund.[12] Where client monies are paid into a "house" account, the whole account would, then, be treated at law as trust property for the protection of the clients, until the trust monies had been accounted for, on the presumption

9 This situation is structurally similar to the statutory trusts considered, against the background of the general law of trusts, in the Lehman Case.

10 *Hunter v Moss* [1993] EWCA Civ 11. However, see the discussion in section 2 below.

8 See *Pearson and others v Lehman Brothers Finance SA and others* [2010] EWHC 2914 (Ch), paragraph 233.

12 *Re Kayford* [1975] 1 WLR 279 at 282.

that the Firm could be presumed to have dissipated its own funds before drawing on trust funds.[13]

28. However, the existence of a trust and the vindication of beneficial rights under that trust are two different things. In the absence of rules specifying the entitlements that a client would have with respect to a Firm's "house" account, the common law proprietary remedies may be very difficult to apply. This is discussed further in section 2 below.

29. To give effect to Option 2, the FSA could consider the changes to CASS 7.7.2 set out in Annex One to this paper.

Option Three - the Point of receipt into the Firm's general estate

30. Option Three involves establishing a trust at the point at which client monies which ought to have been segregated, but were not, are received into a Firm's general estate.

31. Option Three raises issues of certainty of subject matter. One way in which the Firm may receive the monies is through a bank transfer received from the client's bank. In this respect, the client's chose in action as against its own bank would be extinguished when its account is debited and a corresponding chose in action does not arise when a credit appears on an account provided by the Firm—at least in so far as the Firm also purports to be the account holder—for reasons that have been discussed below. Nevertheless, although there is no corresponding individual chose in action, a payment is made by the client's bank to the Firm. That payment may be made through the medium of a payment service which operates as a net settlement system. The individual payment itself will in the course of transmission become indistinguishable from the fungible mass of payments and, in any event, cannot be separately identified once netting has taken place.

32. Given that interbank payment systems consolidate payments and may also net them, the better analysis is that the Firm does not receive the client monies themselves as property but rather, as a result of the client's instructions to his own bank, observes an increase of its general funds—whether by means of a larger net interbank payment to it or a smaller net interbank payment from it. If this is correct, there are no individual payments or receipts from clients to which a trust can attach.[14]

33. Moreover, a trust cannot attach to a proportion of the Firm's general funds to reflect the amount by which those funds have increased as a result of the client's payment. Although it is

[13] See *Re Hallett's Estate* (1879) 13 Ch D 696 at 719. It is worth noting that, at common law, clients will lose the benefit of their trust property in the house account once the balance of the mixed bank account has been reduced to zero and has risen again – see paragraph 36 of this FMLC Paper.

[14] In this sense, account records take a functional, rather than a literal approach in referring to the receipt of client monies.

well-established, following *Hunter v Moss*, above, that a trust over part of a fungible mass will not fail for uncertainty merely because there has been no specific appropriation for the account of the beneficiary, it remains the case that a trust cannot attach to part of a shared fund unless both the fund itself and the beneficiary's proportionate share of it are or can be sufficiently identified.[15] A fund which is indistinguishable from the putative trustee's general assets is not sufficiently certain for these purposes.

34. In light of the uncertainties which Option Three would create (thereby raising questions as to the extent to which it would be consistent with MiFID's objective in enhancing client protections) and Option Two which would address more proportionately the mischief which Option Three also seeks to address, the adoption of Option Three is questionable.

SECTION 2 – THE EFFECT OF THE STATUTORY TRUST

35. As set out above, even if the more generous Option Two is chosen, further rules will be required to address the issue of what is included in the statutory trust and the nature of the claims with respect to the statutory trust. This would, in turn, determine who would participate in the "Client Money Pool" referred to in CASS 7A. In this respect, there are issues which the Lehman Case highlights governing the nature and content of the statutory trust, which a change to CASS or other legislative amendments would need to address.

Difficulty with tracing and proprietary remedies

36. In *Global Trader*, a further case in which the High Court had to consider the nature and effect of the statutory trust in CASS 7, Sir Andrew Park expressed the view that it would be very difficult to establish a tracing case in respect of client margin paid into a Firm's "house" account. The reasons for this he said were that the accounts were active trading accounts of a busy company and they frequently went into overdraft. Where the balance of a mixed bank account is reduced to nil after trust monies have been transferred into the account, and subsequently rises again, the beneficiary of the original trust monies does not have any entitlement in respect of the new, augmented bank balance. This is a consequence of the combined rules in *Clayton's Case* (1816) 1 Mer 572 and *Re Hallett's Estate 13 Ch.D. 696.*

37. *Clayton's Case* itself also gives rise to another consequence which may be thought to be unduly harsh towards beneficiaries: the consequence that those whose monies are paid into the account first are presumed to have been the first to lose their entitlement to any remaining monies in the mixed trust account in the event of a gradual dissipation of those monies. This

[15] See *The Joint Administrators of Lehman Brothers International (Europe) (In Administration) v Lehman Brothers Finance SA and others* [2010] EWHC 2914 (Ch) at 243.

means that a shortfall in a trust account is borne disproportionately by the beneficiaries of longest standing leaving later beneficiaries (or clients) to share the reduced balance amongst themselves. It might also complicate a tracing exercise where money is, for example, transferred out to a parent or group company for liquidity management purposes.

38. *Global Trader* further highlights the uncertainty around the nature of the claims with respect to the statutory trust over client money held in the "house" account.

Difficulties with uncertainty of objects

39. As mentioned above, a trust will not fail for want of certainty of object merely because the monies form part of a fungible mass which is beneficially shared with the trustee provided that the fungible mass itself is clearly defined.[16] However, in the context of client monies, two particular issues, one for Firms generally and the other for Firms, specifically universal banks, that purport to provide client money accounts themselves, could arise.

Receivables: debts owed by the Firm to the client

40. In some circumstances a client monies responsibility may arise even though a Firm is not in receipt of client monies: for example, where a client owns a claim against the Firm as a result of a derivative contract into which both parties have entered ("Receivables"). Such a claim may comprise a liquidated debt or an open position under a contract which at the point of insolvency has yet to be closed out or self generated indebtedness, such as dividends.

41. The treatment of an open position was considered in the *Global Trader* case, where Sir Andrew Park held that the Firm's liquidators could in theory be required to transfer monies into pre-existing segregated client monies accounts representing the value of the positions on the basis of a notional close out at the date of entry into administration.

42. It is clear from the judgment that he was only prepared to make this order because the clients in question already benefitted from segregated client monies accounts subject to the statutory trust. However, the monies which were to be transferred by the liquidators were, by definition, not yet segregated and the liquidators had to take them from the Firm's "house" accounts.

43. It is unclear from *Global Trader* whether the judge thought that the statutory (or some other, e.g. constructive) trust attached to the monies while they were still in the "house" account or whether he was making the order on different grounds. It appears that the judge took the view that CASS 7.9.6 had conferred an innominate entitlement on affected clients, because it referred (prior to its deletion in 2008) to a "pooling event". It, therefore, contemplated the administration itself, in a way in which the primary FSA rules on segregation do not. Park J

16 *Hunter v Moss* [1993] EWCA Civ 11.

explained that the court would not make good the company's regulatory default in failing to segregate client monies in the first place. However, it would make good, retrospectively, any failure to segregate monies representing increased value on notionally closed out derivative positions where clients already had the benefit of segregation in respect of other monies.

44. However, the nature of the mechanism by which the clients' entitlement is conferred – whether by operation of a trust on the house monies account at the point of notional closing or by some other means entirely, such as an administration expenses liability – is unclear. This means that it is unclear how the rule would apply in situations where the derivative position is held by a client who does not yet have a segregated client account or in situations where there is no money in the house bank account to transfer into such an account and the only funds available are those in the general estate.
45. The Lehman Case also highlights the issue of Receivables with one of the questions for the Court being: "Do clients participate in the Client Money Pool if they have claims to client money or only if they have contributed to the Pool ('Issue 3')?"
46. Arden LJ held that Lehman clients should share in the Client Money Pool on a "claims basis":

> "The more difficult question is whether those who have only a contractual right but no proprietary right should also share. In my judgment, Mr Miles' approach is to be preferred. The underlying concept of "client money entitlement", the term used in CASS7.9.6 R(2), is that of contractual entitlement. The effect of this interpretation is that some clients will benefit from a distribution even if they have no proprietary claim to client money."[17]

47. However, in addressing the further question: "when does money which the Firm owes to a client become client money ('Issue 4')?", Arden LJ held that "self-generated indebtedness" (such as manufactured dividends) does not constitute client money:

> "Where there is no property which is sufficiently identified to form the subject matter of a trust, no trust is created. In *Hunter v Moss*, the shareholding was in existence; the shares were fungible and thus the trust property could be identified. The same would be true if Lehman had an account called "manufactured dividends" into which it paid whatever was found to be due at each reconciliation on account of such dividends, and held for the benefit of clients entitled to manufactured dividends. However, it does not suffice under the general law that Lehman had sufficient funds in some other account

[17] Paragraph 154.

which could have been dedicated for this purpose but which was not so used. Turning to CASS 7, there is no indication in CASS7.2.1 R that the definition of "client money" is intended to create a trust in circumstances where the relationship under the general law could never be anything more than that of debtor and creditor."[18]

On one reading, Issues 3 and 4 relate to two entirely different questions, i.e. "who is entitled to participate in the Client Money Pool?" versus "which monies go into the Client Money Pool?" However, on another reading, both questions are sufficiently linked such that the apparently different approaches give rise to uncertainty as to whether self generated indebtedness forms part of the client's entitlement to the Client Money Pool from the moment the indebtedness is generated even if no money has yet been transferred into a client money bank account.[19]

Client money received by a Bank

48. In the case of Firms that are universal banks, problems may arise which are closely related to, or a sub-set of, the issues discussed at paragraphs 31 to 33 above. Client money, which ought to be segregated as such, may initially be received by the Bank by means of a transfer to an account number corresponding to an account provided by the Bank itself.[20] Where the account is held by the client, the client initially obtains, pending transfer into an account at a third party bank, merely a contractual entitlement against the Bank and no client money protection is conferred. Moreover, at law the Bank cannot act as trustee of its own indebtedness to the client under a statutory—or, indeed, any other—trust. Alternatively, if the money so received is not paid into an account opened for the client but is received into an account in the name of the Bank itself—i.e. an account which it purports both to hold and to provide—then the problem is more fundamental. There is no property over which a client money trust can be constituted. Both these situations are explained further below.

Account in the name of the client

49. A bank account is a chose in action wherein the account provider is the debtor and the account holder is the creditor. In these circumstances, the account provider cannot hold a proprietary interest in the account that amounts to title or a right to possession. This is well-established by the decisions in *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd*

18 Paragraph 171.

19 The FMLC also notes that the calculation of client indebtedness may not always be straightforward, particularly where, for example, where there are questions surrounding the point at which open market contracts may, or should be, closed out.

20 The FMLC notes the market trend for such institutions no longer to offer client money services.

[1972] AC 785 at 802 and 810; *Re Charge Card Services* [1987] 1 Ch 50, affirmed [1988] 3 All ER 702; and *Re BCCI (No. 8)* [1994] 3 All ER.[21]

50. In the *Halesowen* case, Lord Cross made the point that a bank cannot have a lien on its own indebtedness to a creditor. This was followed by the well known case of *Re Charge Card Services Ltd.* where, at first instance, Millett J explained that the notion of a bank having a proprietary interest in an account which it provides is a conceptual impossibility.

51. In *BCCI (No 8)*, Lord Hoffmann doubted whether there was any doctrine of conceptual impossibility which was drawn so widely as to prevent a bank enforcing against its customer an equitable charge over an account held by that same customer. He did not, however, call into question the conceptual impossibility of a bank having title to, or a right to retain possession of, an account which it provides and explained *Halesowen* as a case of the latter type.

52. A trust cannot exist without conferring on the trustee title to trust property. If a Bank cannot have title to its own indebtedness, it cannot act as trustee over an account which it provides in the name of its client.

Account in the name of the Bank

53. The point is even more compelling in the case of a bank account which the Bank maintains in its own name.

54. In the ordinary course, a credit to a bank account is a chose in action which is brought into existence *ab initio* at the moment of entry in the account book and which represents a debt owed by the account provider to the account holder (*Re Preddy* [1996] AC 815). However, no chose in action can come into being if the account holder and the account provider are the same person. Therefore, where a bank is both the account provider and the putative trustee, there is no property to which a trust can attach.[22]

55. The limitations discussed above have the consequence that a trust of client money cannot arise at the point of receipt if the money is deposited in, or transferred to, an account which the firm itself, being a universal bank, has the capacity to provide. The difficulties involved are an example of the difficulties discussed in paragraphs 31 to 33 above.

56. These conceptual difficulties cannot normally arise in the case of client money received by a firm which is not a bank and not, therefore, able to accept deposits. In the case of investment firms, money received by bank transfer will always be deposited into an account at a third party bank.

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21 In *BCCI (No 8)*, Lord Hoffmann explained that a charge over the account in favour of the account provider could nevertheless take effect in contract.

22 On the other hand, if the Firm is not the account holder then entries in the account represent its indebtedness to the account holder and, since title is vested in another person, there is no property *vested in the Firm* to which a trust can attach.

Shortfalls

57. The policy solution which has been adopted by the FSA with respect to segregated accounts is to provide for the "pooling" of client accounts. Where a shortfall occurs because, say, the segregation has not taken account of the notional closing open positions between the client and the Firm, *Global Trader* suggests that the court will be prepared to order a transfer of general funds to make good the shortfall in the segregated account.
58. However, as set out above, the difficulties surrounding the extent and nature of the entitlement and the appropriate remedy or power necessary to give effect to this entitlement create a doubt as the effectiveness of any statutory or constructive trust. It is unclear whether the court order in these circumstances would recognise a proprietary entitlement (under a statutory or constructive trust), a personal liability on the part of the administrator, or a *sui generis* regulatory obligation.

SECTION 3 – POLICY OPTIONS AND SOLUTIONS

A Power of Transfer

59. To the extent that the FSA and/or HM Treasury were minded to adopt a policy whereby monies that ought to have been placed in segregated accounts but were not are transferred or become eligible for transfer to the Client Money Pool, an amendment to CASS which has an effect similar to that in section 78fff-2(c)(3) of the US Securities Investor Protection Act 1970 ("SIPA") could be an option.
60. SIPA deals with the liquidation of registered broker-dealers in the United States and provides the customers[23] with various protections including a priority for return of assets over general unsecured creditors.[24]
61. Section 78fff-2(c)(3) deals with the "recovery of transfers". It states:

> "Whenever customer property is not sufficient to pay in full all the claims set forth in [section 78fff-2(c)(1)], the trustee may recover any property transferred by the [bankrupt broker-dealer] which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of title 11 [Bankruptcy]. Such recovered property shall be treated as customer property. For purposes of such recovery, the property so

[23] Section 78lll(2) of SIPA defines "customer" as "any person... who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting the transfer."

[24] Section 78fff-2(c)(1) of SIPA establishes a mechanism for the allocation of "customer property" by a trustee in bankruptcy of a broker dealer.

transferred shall be deemed to have been the property of the [bankrupt broker dealer] and, if such transfer was made to the customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any State notwithstanding."

62. Amending CASS to insert a broadly analogous provision (reflected in the draft language set out in Annex One to this paper) would enable an administrator to transfer any money to a Firm's client to which he is entitled as a result of any regulatory duty (to segregate) owed by the Firm to the client into the Client Money Pool from:
    a. the "house" account; or
    b. any account into which money to which the client would be entitled was transferred from the "house" account.

63. In considering the suggested amendments, the FSA would need to note that:
    a. the amendment is not designed to remedy shortfalls *per se* but rather as part of a broader remedy to treat as done that which ought to have been done, *i.e.* to give effect to any transfers that ought to have taken place prior to a "primary pooling event";
    b. for any amendment to be effective, the FSA would need to liaise with HM Treasury to ensure that the appropriate changes were made to the IBSAR and rules made under the IBSAR, particularly with respect to:
        (i) an administrator's determination of what was to be included as part of the "client equity balance" pursuant to CASS 7A.2.2.5 R (including, to ensure that the administrator does, in fact, adhere to CASS 7A.2.5 which like all of CASS 7A only applies to a Firm);[25] and
        (ii) the actual power to recover/require the payment of any monies to allow for the distribution of the full client entitlement pursuant to CASS 7A.2.4 R.
    c. The definition of "client equity balance" would need to be expanded to be consistent with the list of client money entitlements added as part of the suggested amendment to CASS 7.7.2 R. Moreover, as mentioned above the mechanism in CASS 7A.2.5 R goes merely to the calculation of the relevant client money entitlements; it does not provide (expressly) the power to an administrator to recover or require the payment of any monies to make good any shortfall in client money account after making the calculation and setting-off any amounts pursuant to CASS 7A.2.5 R. The IBSAR would need to address these.

[25] See CASS 7A.1.1.

64. It should also be noted that section 78fff-2(c)(3) only allows for limited recovery of customer property and so is a partial remedy. The wording "if and to the extent that such transfer is voidable or void under the provisions of title 11" in section 78fff-2(c)(3), when read with sections 749 and 764 of title 11 of the US Bankruptcy Code, limits recovery to transfers that are void or voidable as:

    a. creditor's lien,[26]
    b. falling within safe harbours from statutory lien,[27]
    c. preferences,[28]
    d. fraudulent transfers,[29]
    e. post-petition transactions,[30] and
    f. as "payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim".[31]

65. An alternative solution following a policy objective of treating that as done which ought to have been done is to add a limited preference regime to CASS.

66. Para. 78lll(4)(a) of SIPA provides a definition of "customer property" which includes:

> "securities held as property of the debtor to the extent that the inability of the debtor to meet its obligations to customers for their net equity claims based on securities of the same class and series of an issuer is attributable to the debtor's noncompliance with the requirements of section 78o(c)(3) of this title and the rules prescribed under such section".

67. This passage prescribes that an insolvent firm's own property may be treated as customer property as if the insolvent firm has indeed segregated it in the customer's account.

68. Inserting a similar provision in CASS, with respect to client *money* (whereas the SIPA remedy relates to securities) would allow for an administrator/financial services regulator to appropriate client money which is in the house account of the Firm to meet a shortfall in the client's net

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26 Section 544(a)(1) of title 11 of the US Bankruptcy Code.

27 *ibid* section 545.

28 *ibid* section 547.

29 *ibid* section 548.

30 *ibid* section 549.

31 *ibid* section 726(a)(4) pursuant to *ibid* section 724(a).

equity claim on the Firm. It would represent a considerable widening of the 'preference' in SIPA which is restricted to shortfalls of securities where the debtor firm has securities of the same class in its house account.

Client money obligations as administration expenses

69. In light of the insolvency of Lehman, concerns arose as to whether CASS 7.2.3 R has the unintended consequence that a client who has posted collateral with a Firm will lose its rights in that collateral where a Firm has exercised its "right to use" that collateral.[32] Upon Lehman's insolvency, some of the clients who had transferred legal title over collateral to Lehman prior to its administration found themselves with nothing more than a contractual claim for return of that collateral. This decision in *RAB Cycles* highlights this issue.
70. *RAB Cycles* concerned US Treasury Bills which had been expressly excluded from Lehman's right of rehypothecation[33] under the prime brokerage agreement between Lehman (the broker) and RAB Market Cycles (Master) Fund Limited ("RAB"). Following the appointment of administrators to Lehman, Lehman could not reinvest the US Treasury Bills and RAB was unable to finance separately the purchase of replacement Treasury Bills. Lehman administrators relied on various insolvency moratoria to withhold the Treasury Bills. Shortly after the appointment of administrators to Lehman, the Treasury Bills matured and were converted into cash.
71. Lehman's administrators applied for directions as to whether clause 5.2 of the prime brokerage agreement applied to the cash received by Lehman upon the appointment of the administrators to Lehman.[34] In other words, the Court was asked whether Lehman had absolute ownership over cash received after it entered insolvency.
72. The Court concluded that an implied temporal limit on clause 5.2 expired upon Lehman's insolvency or failure to perform its obligations under the prime brokerage agreement and RAB would retain the same proprietary interest in the cash received after the Treasury Bills matured as it previously had in the Treasury Bills. The Court also held that the cash would be classed as client money and paid to RAB; and even if the temporal limit placed on clause 5.2 was incorrect,

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32 CASS 7.2.3R governs title transfer collateral arrangements. The basic rule under CASS 7.2.3R is that where a client transfers full ownership of money to a Firm for the purpose of securing or otherwise covering present or future actual or contingent or prospective obligations, such money should no longer be regarded as client money.

33 The right of rehypothecation permits a securities broker to use the same securities posted with it by a client as collateral for a loan on a margin account, to secure a loan from a bank to cover the broker's exposure to potential margin account losses.

34 Clause 5.2 of the prime brokerage agreement provided: "The parties acknowledge and agree that any cash held by us for you is received by us as collateral with full ownership under a collateral arrangement and is subject to the security interest contained in the Agreement. Accordingly, such cash will not be client money pursuant to the Rules (or any successor provisions thereto) and will not be subject to the protections conferred by the Rules. Such cash held by the Prime Broker will not be segregated from the money of the Prime Broker or any other counterparty of the Prime Broker and will be held free and clear of all trusts. The parties further agree that the Prime Broker will use such cash in the course of its business and the Counterparty will, therefore, rank as a general creditor of the Prime Broker in respect of such cash."

the cash derived from the Treasury Bills should still be paid to RAB as an expense of the administration because they were only received and retained by Lehman administrators by way of insolvency moratoria.

73. RAB Cycles highlights the possibility of allowing a client's claim in respect of client monies to be addressed as an administration expenses liability by the administrator.

74. In Re *Japan Leasing (Europe) plc* [1999] BPIR 911 ("*Japan Leasing*") the court considered whether certain payments received by a company after it entered into administration could be regarded as expenses of the administration. A court may regard retention of funds received by administrators as an unconscionable attempt to obtain a windfall for the estate and contrary to the principle that, as an officer of the court, an insolvency practitioner will be held to a higher standard of conduct.[35] Thus, the court would almost certainly consider that, if an administrator were to receive any client monies *after* the date of entry into administration, it would be unconscionable for the administrator to retain those monies and the monies could, in theory, be regarded as an expense of the administration.

75. In *Japan Leasing* the administration expenses liability rested on the (fictional) supposition that the administrator has elected to continue the company's role for the benefit of the estate. However, in reaching this conclusion the judge relied heavily on a passage from the judgment of Nicholls LJ in *Re Atlantic Computer Systems plc* [1992] Ch 50 which was subsequently disapproved by Lord Hoffmann in *Re Toshoku Finance UK plc* [2002] UKHL 6; [2002] 3 All ER 961 at 971. Lord Hoffmann refused to accept, in the context of a liquidation, that obligations under pre-insolvency contracts could be precisely assimilated to post-insolvency debts for the purposes of determining what constitutes a liquidation expense or that there is any discretion reserved to the court to determine what is an expense on the just and equitable ground. The conclusion in *Japan Leasing* as to administration expenses should therefore be treated with some caution (although the general principle in *ex p. James* is still applicable to the payments enriching the insolvent estate).

76. In *Toshoku* Lord Hoffmann said that liquidation expenses in respect of pre-insolvency contracts would:

> "include debts which, under the *Lundy Granite Co* principle, are deemed to be expenses of the liquidation. *Ordinarily this means that debts such as rents under a lease will be treated as coming within para (a)*, but the principle may possibly enlarge the scope of other paragraphs as well" (own emphasis).

[35] *Ex p. James, re Condon* (1874) L.R. 9 Ch.App. 609.

77. In *Goldacre (Offices) Ltd v Nortel Networks UK Ltd (in administration)* [2010] 2 BCLC 248 His Honour Judge Pearle QC applied *Toshoku* in the context of an administration to obligations to pay rent under a lease which was entered into by the pre-insolvent company and then adopted by the administrators. The judge confirmed that the court does not have any discretion to decide whether a given cost or expense constitutes an expense of the administration.
78. Two months *earlier* in *RAB Cycles*, Briggs J took the view, *obiter*, at 109 that the *Lundy Granite* principle would allow debts arising from the administrator's retention of client securities to be deemed expenses of the administration on the grounds that the administrators had "resisted [the securities'] delivery to Counterparties on demand, because to have done so would have been contrary to the efficient conduct of the administration. It has therefore been for the better conduct of the administration that the securities have thus far been retained."
79. He went on to say: "By contrast it is no part of the purpose of the administration that the unsecured creditors of Lehman should obtain a consequential windfall at the Counterparties' expense. Payments of sums equivalent to [the debts] are therefore necessary disbursements, because they are necessary in order to remedy the injustice which the retention of that windfall would otherwise bring about."
80. These passages were considered in *Goldacre* where the judge, at 13, observed the difficulty of bringing Briggs J's *obiter* remarks within the proper scope of the *Lundy Granite* principle. Judge Purle also held that, at least in relation to rent, the liability in question cannot be regarded as an expense until the administrator has used the property and/or taken a decision to retain it. This suggests that, at the very least, the administrator's decision to resist the transfer of any monies out of the estate must be an active one and not merely the result of general confusion and uncertainty at the outset of a large, complex administration.
81. Realistically, a reluctance to return client monies immediately to the clients on the part of an administration would almost certainly be properly attributable to the administrator's desire to investigate the legal and operational complexities of the insolvent Firm's position rather than a desire to take advantage of a windfall. Nonetheless, there may still be scope to argue that client monies should be paid to the client as an administration expense on the grounds that the administrator is deemed to have "resisted" their immediate transfer "for the better conduct of the administration".[36] Recent authorities have suggested that such an argument is plausible in certain circumstances but are not wholly clear as to its scope.[37]

36 *RAB Cycles* at 109.

37 See *RAB Cycles* and *Goldacre*.

Application of this alternative remedy

82. The alternative remedy would operate as a "belt and braces" remedy in addition the remedies referred to above. In order to give effect to the alternative remedy, changes to Table 1 of the IBSAR, which applies Schedule B1 of the Insolvency Act 1986 would be necessary.[38] This would need to indicate that paragraph 63 of Schedule B1 was modified to permit the administrator to apply to court for an order making the client money obligations part of the administration expenses.

83. In addition to changes to the IBSAR, changes to Part 4 (Expenses of Special Administration) of the recently enacted Investment Bank Special Administration (England and Wales) Rules 2011 ("IBSA Rules") would be necessary. In particular, Rule 283 would need to make it clear that the "fees, costs, charges and other expenses" included any client money obligations "as expenses of the special administration".

Priority of expenses

84. Administration expenses usually rank in priority to the administrator's own remuneration.[39] If this were thought undesirable from the perspective of the policy of not deterring insolvency practitioners from taking office, appropriate amendments to paragraph 99 could achieve a different order of priority for "client money expenses".[40]

85. Moreover, in the unlikely event that an investment firm is subject to liquidation proceedings, the general rules as to priority of expenses in Rule 4.218 of the Insolvency Rules 1986 would also need to be amended to reflect client money obligations.

CONCLUSION

86. As is the case with the policy options discussed in Section 2 above, although not involving an amendment to CASS, the alternative remedy is intended to enhance the protections in CASS and not replace them. Notwithstanding that the FSA is not charged with amending the IBSAR or IBSA Rules, the FSA should discuss these options with HM Treasury.

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[38] Paragraph 63 of Schedule B1 of the Insolvency Act 1986 provides for the administrator of a bankrupt to apply to the court for directions in connection with his functions.

[39] See the Insolvency Act 1986, Schedule B1 paragraphs 99(3) and 99(4).

[40] Parallel amendments to the IBSAR would also need to be considered.

Annex One – suggested amendments to CASS

...7.7.2 R [A firm receives and holds client money as trustee (or in Scotland as agent) both before and after segregating such client money by placing it into one or more bank accounts in accordance with CASS 7.4.1 R on the following terms:

(1) for the purposes of and on the terms of the client money rules and the client money distribution rules;

(2) subject to (4), for the clients (other than clients which are insurance undertakings when acting as such with respect of client money received in the course of insurance mediation activity and that was opted in to this chapter):

(a) from whom that money is received;

(b) for or on behalf of whom that money is held;

(c) to whom the firm is under a legal [or regulatory] obligation to pay that money such that it forms part of the client equity balance for that client; or

(d) to whom another person is under a legal [or regulatory] obligation to pay that money by transferring the money to the firm to be treated by the firm as client money for and on behalf of the client such that it forms part of the client equity balance for that client,

according to their respective interests in it;

(3) after all valid claims in (2) have been met, for clients which are insurance undertakings with respect of client money received in the course of insurance mediation activity according to their respective interests in it;

(4) on failure of the firm, for the payment of the costs properly attributable to the distribution of the client money in accordance with (2); and

(5) after all valid claims and costs under (2) to (4) have been met, for the firm itself.]...

client equity balance — *the amount which:*

(a) *a 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 legal [or regulatory] obligation [arising prior to a primary pooling event] requiring a firm to pay money of any currency to a client, including but not limited to his* *margined transactions if each of his open positions was liquidated at the closing or settlement prices published by the relevant exchange or other appropriate pricing source and his account closed. This refers to cash values and does not include non-cash collateral or other designated investments held in respect of a margined transaction; and/or*

<u>(b)</u> *A person (other than the firm) would be liable in respect of any <u>legal [or regulatory] obligation [arising prior to a primary pooling event] requiring a that person to pay money of any currency to a client by transferring the money to the firm to be treated by the firm as client.</u> ...*

client money *...(2A) (in CASS 6~~,~~ <u>and</u> CASS 7 ~~and CASS 7A~~ and, in so far as it relates to matters covered by CASS 6, CASS 7, or COBS) subject to the client money rules, money of any currency:*

(a) that a firm receives or holds for, or on behalf of, a client in the course of, or in connection with, its MiFID business; and/or

(b) which, in the course of carrying on designated investment business that is not MiFID business, a firm holds in respect of any investment agreement entered into, or to be entered into, with or for a client, or which a firm treats as client money in accordance with the client money rules.

<u>(2B) (in CASS 7A and in so far as it relates to matters covered by CASS 6, CASS 7, or COBS) money of any currency;</u>

(a) <u>which a firm receives or holds for, or on behalf of, a client in the course of, or in connection with, its MiFID business; and/or</u>

(b) <u>in respect of any client equity balance arising in the course of, or in connection with, the firm's MiFID business.</u>

(c) <u>which, in the course of carrying on designated investment business that is not MiFID business, a firm holds in respect of any investment agreement entered into, or to be entered into, with or for a client, or which a firm treats as client money in accordance with the client money rules.</u>

(d) <u>in respect of any client equity balance arising in the course of carrying on designated investment business that is not and in respect of any investment agreement entered into, or to be entered into, with or for a client.</u> ...

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