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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 147: CLIENT MONIES

Response to the FSA Consultation Paper entitled "Client assets regime: EMIR, multiple pools and the wider review" (CP12/22)

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INDEX OF DEFINED TERMS

"CASS" means the FSA Client Assets Sourcebook

"CCP" means Central Counterparty

"COMI" means centre of main interests

"CP12/22" means the FSA Consultation Paper "Client assets regime: EMIR, multiple pools and the wider review" of September 2012

"CRD IV" means the proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (dated 20 July 2011)

"CRR" means the Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (dated 20 July 2011)

"EMIR" means Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (otherwise known as the European Market Infrastructure Regulation)

"EUIR" means Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings

"FMLC" or "Committee" means the Financial Markets Law Committee

"FSA" means the Financial Services Authority

"FSCS" mean the Financial Services Compensation Scheme

"FSMA" means the Financial Services and Markets Act 2000

"LBIE" means Lehman Brothers International Europe

"*LBIE* High Court Judgment" means the judgment of the High Court *In the matter of Lehman Brothers International (Europe) (In Administration)* [2009] EWHC 3228 (Ch). This decision related to an application for directions made by the administrators of LBIE in relation to a range of issues arising under CASS 7. The main effect of this decision was that any client whose money was not segregated by an FSA regulated firm in accordance with CASS 7 would, in the event of the firm's insolvency, be unable to assert a proprietary claim against the pool of segregated client money. This meant that the client would have had to trace that money through the firm's own accounts. Due to the evidential difficulties associated with tracing money, a client in this position was unlikely to be able to substantiate a proprietary claim, and would have had to claim in the firm's liquidation as an unsecured creditor instead.

"*LBIE* Court of Appeal Judgment" means the judgment of the Court of Appeal *In the matter of Lehman Brothers International (Europe) (In Administration)* [2010] EWCA Civ 917. This decision overturned the decision of the *LBIE* High Court Judgment in relation to client money held by LBIE through its London affiliate. The Court of Appeal held that the client money available for distribution on a priority basis should extend to identifiable client money not held in segregated accounts and that clients whose monies had not been segregated should also be entitled to share in the client money pool. However, the Court of Appeal did agree with the decisions made in the *LBIE* High Court Judgment on two other substantive issues: first, that the statutory trust arose as soon as the client monies were received by LBIE; and second, that a debt which LBIE owes to a client cannot be treated as client money until an amount is appropriated to the client.

"*LBIE* Supreme Court Judgment" means the judgment of the Supreme Court in *In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986* [2012] UKSC 6. In this decision the following three issues were considered in relation to the construction of CASS 7: (i) when does the statutory trust created by CASS 7.7.2R arise; (ii) do the primary pooling arrangements set out in CASS 7A apply to client money held in house accounts; and (iii) is participation in the notional client money pool dependent on actual segregation of client money. The *LBIE* Supreme Court Judgment dismissed the appeal by a majority from the decision in the *LBIE* Court of Appeal Judgment and held that: (i) the statutory trust that applies to client money under CASS 7 arises upon receipt of the client money by the institution, and is not dependant on the institution actually segregating the money; (ii) the client money pool available for distribution on an insolvency event is comprised of all funds being identifiable as client money, irrespective of which account the money resides in or was received by; and (iii) the client money pool is to be distributed among all clients having an entitlement, and that clients' entitlements are to be dependent on their respective contractual claims.

"MF Global" means MF Global UK Limited

"MiFID" means Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments

"PS12/23" means the FSA Policy Statement dated December 2012 in relation to Part 1 of CP12/22

"SFD" means the Settlement Finality Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009

"SFRs" means the Financial Markets and Insolvency (Settlement Finality) Regulations 1999

"TTCA" means Title Transfer Collateral Arrangements

1. INTRODUCTION

Introduction

1.1. The role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. The FSA published CP/12/22 in September 2012 and, shortly thereafter, invited the FMLC to respond. This paper addresses the questions in the consultation through the lens of legal uncertainty.

1.3. This paper does not comment on policy issues other than as it has judged necessary in order to deal with issues of legal uncertainty or misunderstanding.

1.4. The paper consists of three sections which consider, respectively: (1) issues concerning margin, segregation and porting, (2) issues concerning the proposals for introducing multiple pools, and (3) issues concerning the treatment of client assets in a firm's insolvency.

2. PART 1 OF CP12/22

2.1. This section responds to Part 1 of CP12/22 concerning proposed changes to CASS to address the margin segregation and porting provisions found in EMIR. Notwithstanding the publication of PS12/23 setting out the final rules in relation to Part 1 of CP12/22, the FMLC believes it important to respond to the issues raised within it because they also relate to wider issues concerning the reforms to the client money regime. Also relevant is the informal consultation on segregation and porting carried out by HM Treasury.[1] This concerned proposed changes to the insolvency provisions in Part 7 of the

1 See the letter from the FMLC to Mr Ola Ajadi of HM Treasury dated 5 November 2012.

This letter along with most other FMLC letters and papers is available at www.fmlc.org.

Companies Act 1989, the Recognition Requirements Regulations, the Settlement Finality Regulations and the Financial Markets and Insolvency Regulations which was not referred to in CP 12/22 nor in the final rules made in PS 12/23.[2]

Defining client money entitlement

2.2. Most CCPs have allowed clearing members to distinguish between client and house accounts in respect of money transferred to the CCP by way of margin (where relevant, relying on provisions in Part 7 of the Companies Act 1989) for administrative purposes. Most CCPs do not, however, recognise any third party beneficial interest in respect of the cash transferred into these margin accounts. A firm is able, as part of its client money reconciliation, to bring into the calculation of its client money requirement the net aggregate of the firm's equity balance on transaction accounts maintained in respect of clients at CCPs.[3] This allows some means of reconciling a client's "client money entitlement" with the firm's client money resources as it brings into account positive net amounts due on transaction accounts at CCPs (on the basis of a notional close out of all the client positions at the time the reconciliation is performed). The net positive or negative aggregate value of these positions will normally be mirrored by a corresponding equity balance as between the firm and the client where back to back contracts between the clearing member and the client have been transacted. The FMLC believes that legal certainty would be promoted if the rules reflected the status of the money following its transfer to the CCP. The FMLC does not believe that this would cut across the proposal in CP12/22 that makes clear that a firm will be treated as having discharged its fiduciary duty owed to its clients under CASS if a CCP, acting under its default rules, transfers, or "ports", margin to another, solvent, clearing member.

2 The Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001; The Financial Markets and Insolvency (Settlement Finality) Regulations 1999; The Financial Markets and Insolvency (Settlement Finality) Regulations 1999.

3 CASS 7 Annex 1 G, paragraph 14.

Client Money Distribution Rules - What happens if client money is misallocated?

2.3. The rules in CASS are based upon the premise that the FSA makes rules that result in the holding of client money by an authorised firm on trust in accordance with those rules.[4] The FSA can therefore specify the circumstances in which such a trust arises and may specify the terms of the trust, including the beneficial interests arising under the trust.

2.4. The judges' comments in the *LBIE* Supreme Court Judgment indicate that the relevant provisions in CASS (now in chapters 7 and 7A) should be interpreted as giving rise to a statutory trust on a firm's receipt of client money. Currently, where there is an insolvency of a firm, the rules require all client money held by the firm to be notionally pooled in a single pool and distributed according to clients' respective interests as set out in FSA's Client Money Distribution Rules (CASS 7A).[5]

2.5. One consequence of this, and of the *LBIE* Supreme Court Judgment more generally, is that where a firm misallocates money received from a client, for example by paying client money into a house account other than in accordance with CASS, the client may nevertheless have a claim on the identified pool of client money that was properly allocated; to the extent possible, misallocated client money that can be identified in other accounts (for example a house account) may be added to the client money pool. It is unclear whether it is intended that the rule changes proposed in Part 1 of CP12/22 should alter this premise.

2.6. The changes required by EMIR in Part 1 of CP12/22 appear consistent with the objectives set out in Parts 2 and 3, namely, to speed up the return of clients' funds and assets in the event of insolvency. The FMLC notes, however, that if a consequence of creating multiple client money pools is that it becomes less

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4 Section 139 of FSMA.

5 The *LBIE* Supreme Court Judgment is briefly discussed in the Index of Defined Terms section at the front of this paper and at paragraph 4.5.

clear what is to happen in the event that a firm has misallocated money—either by appropriating such money to itself or by allocating it to the wrong pool—the risk of delay, uncertainty and litigation are likely to increase. If firms operate multiple pools, in practice, the risk of misallocation appears to increase as well.

2.7. It is the FMLC's view that legal certainty would be increased if the rules proposed in Part 1 of CP12/22 were to address this misallocation risk. According to the final rules, if a firm misallocates client money received from, or due to, a client for whom it undertakes cleared derivatives business, the implication is that the client will not (in respect of that shortfall) have a claim on excess margin (i.e. margin in excess of the client's requirement) distributed from the client transaction account at the CCP.[6] It is not clear whether a client in this situation will have a claim on the general client money pool. The rules in CP12/22 addressing EMIR in effect make provision for a separate client money sub-pool to accommodate the situation where margin monies are not ported but returned to the defaulting firm for the account of individual clients and for whom the firm has undertaken to maintain individual segregation.[7] Accordingly, the issues addressed in Part 2 of CP12/22 concerning sub-pools also arise in relation to Part 1. It may be necessary and desirable for the rules expressly to establish different trusts for clients corresponding to the separate pools of client monies rather than seeking to differentiate them solely by reference to distribution rules concerning what continues to be a single client money trust.

TTCA and transfers by a CCP to a defaulting firm for the account of clients

2.8. If clients in effect opt out of CASS protection by agreeing to a TTCA then

6 This appears to be because the intention is that claims on such monies should be on a "contributions" rather than a "claims" basis. (A brief description of the "claims" basis and the "contributions" basis is included at footnote 21 of this paper.)

7 Draft rule 7A.2.4 R (3)(a) of CASS.

money transferred to the firm will not be client money.[8] (As such, the following discussion relates to non-client money, which is outside the scope of CASS.) As far as the CCP is concerned this ought not to interfere with the facilitation of the porting of funds distinguished in their accounts for individual clients or for clients generally in an omnibus account. However, such funds that cannot be ported must be returned either to the clients (if the CCP can identify them) or to the clearing member for the account of its clients (if the CCP cannot) in accordance with Article 48(7) of EMIR.

2.9. If in these circumstances a CCP is able to identify the clients to whom the funds should be returned, the legal efficacy of the transfers made directly by the CCP to such clients will not be in doubt if they are protected under the proposed amendments to Part 7 of the Companies Act 1989.[9] Transfers of excess margin by a CCP to the defaulting clearing member also appear to be protected.

2.10. The position is, however, less clear in relation to excess margin once it has been returned by a CCP to a clearing member as opposed to having been transferred directly to clients. This is because the proposed changes to Part 7 of the Companies Act 1989 do not appear to protect transfers made by a clearing member following a transfer of excess margin by a CCP under Article 48(7) of EMIR.[10] On transfer to the clearing member, excess margin becomes the property of the clearing member and is not subject to any client money trust that would confer a beneficial entitlement on clients so as to justify a transfer to them. If excess margin is returned to the firm, it is therefore difficult to see (absent any private law security or trust arrangement) on what basis the insolvency practitioner would not treat it as part of the assets of the clearing

8 Without agreement to a TTCA, client money margin in client transaction accounts at a clearing house is notionally pooled when a firm becomes insolvent (CASS Chapter 7A and referred to at paragraph 2.6 of CP12/22).

9 A transfer by a CCP to a client under Article 48(7) of EMIR would also be a qualifying property transfer that is protected under insolvency law by Section 159(1)(f) of the Companies Act 1989.

10 The proposed definition of "qualifying property transfer" in Section 155(3C) of the Companies Act 1989 includes "transfers" made in accordance with Article 48(7) of EMIR. It is unclear, however, whether Article 48(7) addresses the question of "transfers" to clients by a defaulting clearing member.

member for distribution to the creditors generally.[11]

2.11. It is the case that Article 48(7) of EMIR provides that the funds are to be returned by the CCP to the client or held by the clearing member “for the account of the client” but it is unclear whether EMIR can by itself alter property rights so as to produce a different outcome on insolvency.

2.12. To increase legal certainty in the case in which excess margin is returned in these circumstances it may be desirable for legislation to be in place to bring about the results intended by Article 48(7) of EMIR. In this context, there are two different situations to consider. The first situation is where the CCP is based in the UK: the rules of its clearing system are governed by English law and an English incorporated clearing member becomes subject to English insolvency proceedings. It seems that, if excess collateral is returned by the CCP to the insolvent clearing member in compliance with Article 48(7) of EMIR for the account of its clients, then, as a matter of principle, this ought to be held on trust for the relevant clients. In order to ensure this happens, a new provision should be added to English insolvency law to provide for such an excess to be treated in this way. How this is best achieved is a matter for Parliamentary Counsel. As the new provision would be consequential on Article 48(7) of EMIR, presumably the new provision could be introduced under the power conferred by Section 2(2) of the European Communities Act 1972. As Part 7 of the Companies Act 1989 is already being amended in the light of EMIR, it seems neatest to deal with it here.

2.13. The second situation is where a clearing member becomes subject to English insolvency proceedings but the CCP is based outside the UK and its rules are governed by the law of another jurisdiction. If the CCP is governed by EMIR, it will need to comply with Article 48(7) of EMIR even if it is based in another EU member state. If the insolvent clearing member is a credit institution, investment undertaking or insurance undertaking, the EUIR will not apply to it.

11 A CCP’s contractual arrangements with its clearing members and clients may avoid the kind of problem referred to in this paragraph. For example, a clearing member may enter a security arrangement with clients such that the CCP’s obligation to return excess margin in the event of the default of the clearing member is assigned to the client. Alternatively, the clearing member could agree to hold such excess margin on trust for its clients.

Even if the EUIR does apply but the insolvent clearing member has a UK COMI and the main proceedings are brought in the UK, then English law will determine the question of which assets form part of the insolvent estate (Article 4(2)(b) of the EUIR). This would be subject to the principle that the effect of insolvency proceedings on the rights and obligations of the parties to the system would be governed by the law of the EU member state applicable to the system (Article 9(1) of EUIR). However, as the governing law would have to be consistent with EMIR and the SFD, it seems reasonable to assume that Article 9(1) of the EUIR would not displace Article 4(2)(b) of the EUIR, with the result that English law would normally apply to the question of whether or not excess collateral formed part of the estate of the insolvent clearing member. If this assumption is correct, then a legislative provision of the kind suggested above should also be helpful in this situation. However, if the new provision is added to Part 7 of the Companies Act 1989, it should be expressed to apply whether or not the CCP is recognised under Part 7 of the Companies Act 1989 or designated under the SFRs. If the CCP is based outside the UK, it might not have sought and been granted recognised clearing house status under Part 7 of the Companies Act 1989 or designated system status under the SFRs.

Interaction with Article 296 of the CRR

2.14. Pursuant to Article 296(5) of the CRR, where an institution is a client of a clearing member and is subject to the own funds requirements under CRD IV, it may be able to benefit from advantageous capital treatment of its CCP-related transactions with the clearing member provided that the following two conditions are met:

a. the client’s positions and assets related to such transactions are distinguished and segregated from the positions and assets of both the clearing member and other clients of the clearing member at the level of both the clearing member and CCP (with the result that they are bankruptcy remote from the clearing member and the other clients of the clearing member); and
b. the relevant laws, regulations, rules and contractual arrangements applicable to the clients or the CCP facilitate the porting of the client’s positions and assets on the insolvency of the clearing member to another

clearing member within the relevant margin period of risk in the event of a default or insolvency of the original clearing member.

2.15. The FMLC believes that to the extent that a client's cash collateral is held by a clearing member as client money in a separate individual "sub-pool" established in accordance with the rule proposed in Part 2 of CP12/22, (new CASS 7.10)—the segregation of client money in a sub-pool and the segregation by a CCP of client money in an "individual client account" (as defined in Annex A of CP12/22)—such a client of a clearing member should be able to satisfy the first limb of Article 296(5) of the CRR. Provided therefore that such a client has also satisfied the second limb of Article 296(5) of the CRR, by having arrangements in place for the porting of its assets and positions to a back-up clearing member, it will be able to benefit from the advantageous capital treatment of its CCP-related transactions.

2.16. The FMLC notes that, owing to the advantages of the capital treatment for which Article 296(5) provides, market participants' reliance on the use of sub-pools may be expected to increase. This topic is considered in greater detail below (paragraph 3.1).

2.17. As explained below, it is unlikely that a client that transfers cash collateral to a clearing member under a TTCA would be able to satisfy the first limb of Article 296(5). Paragraph 2.24 of CP12/22 states that clearing members may, in respect of clients who transfer cash collateral to the clearing member on a TTCA basis, open separate individual client accounts at the CCP for such cash collateral. Although such cash collateral would arguably be distinguishable at the clearing member level it would not be legally segregated (or necessarily bankruptcy remote in the event of the default of the clearing member) and therefore the client would not likely be able to satisfy the first limb of Article 296(5).

2.18. However, according to the *LBIE* High Court Judgment, in the absence of changes to Part 7 of the Companies Act 1989, such accounts could be client transaction accounts (and result in their being included in the client money entitlement notwithstanding the use of title transfer) as a result of the segregation from proprietary accounts at the CCP.

2.19. As referred to in the Index of Defined Terms section at the front of this paper, the *LBIE* High Court Judgment related to an application for directions made by the administrators of LBIE in relation to a range of issues arising under CASS 7. The main effect of this decision was that any client whose money was not segregated by an FSA regulated firm in accordance with CASS 7 would, in the event of the firm's insolvency, be unable to assert a proprietary claim against the pool of segregated client money. This meant that the client would have had to trace that money through the firm's own accounts. Due to the evidential difficulties associated with tracing money, a client in this position was unlikely to be able to substantiate a proprietary claim, and would have had to claim in the firm's liquidation as an unsecured creditor instead.

2.20. The lack of clarity regarding collateral under a TTCA may discourage the use of title transfer in favour of the type of cash collateral arrangement described in paragraph 2.14 above.[12]

Varying treatment of credit institutions across Member States

2.21. The FMLC notes that some Member States have interpreted Article 13(8) of MiFID as providing credit institutions with an absolute carve-out from the provisions concerning the protection of clients' funds notwithstanding the wording in Article 18(1) of the MiFID Implementing Directive (2006/EC/72) that makes clear that the carve-out only applies to deposits within the meaning of the Banking Consolidation Directive (2006/48/EC). This can make the position relating to the branches of such banks less clear. For example, where a bank incorporated in another Member State holds segregated client positions at a CCP, those positions will benefit from the default protections in Article 48 of EMIR but it may not be clear that clients will benefit from the protections of the host state client monies rules implementing MiFID. It will be important for Member States to ensure that such inconsistencies do not give rise to

12 It is possible that that the kind of security arrangements referred to at footnote 11 may though satisfy both limbs of Article 296 of the CRR.

uncertainty over the regulatory, equitable or insolvency treatment of client balances held at CCPs and/or any conflicts of law issues which could undermine the client protections envisaged by both MiFID and EMIR.

Proposal to amend the rules regarding the notification and acknowledgement of trust contained within CASS 7.8[13]

2.22. For the reasons set out below, the FMLC does not think the proposal in paragraph 2.20 of CP12/22 will provide for operational certainty owing to the difficulties that arise for the CCP if a firm is able to make a unilateral notification that the money to be held by the firm in the relevant client transaction account is client money. A CCP needs to know that proprietary account collateral can be applied against proprietary account losses.[14] A CCP, as a result of its account structures, may not be able to conform with a unilateral notification, particularly if it affects a proprietary account. An alternative approach would be for any client transaction account to be subject to confirmation as to the fact that monies held in a client transaction account are for the firm's clients, coupled with a requirement that an investment firm place client assets in the correct account among those at CCP level. The acknowledgement from the CCP could also serve to identify the subject matter of the trust (the right of return money as opposed to the moneys themselves).

Liability of CCPs and statutory immunity

2.23. The FMLC believes it might be sensible to consider whether Section 291 of FSMA (*Liability in relation to recognised bodies' regulatory functions*) should be amended to include within its scope immunity from damages for any action taken by a CCP in accordance with its obligations under EMIR. The FMLC is of the view that such immunity may increase the chances that a CCP will port assets.

13 It is noted following Part 1 of CP12/22, in the end the FSA decided not to proceed with these changes.

14 It is noted that, under the proposed wording in CP 12/22 at CASS 7.10.11R, it is a condition for giving notification that the firm arranges either omnibus client segregation or individual client segregation.

3. PART 2 OF CP12/22 – MULTIPLE POOLS

3.1. The client money regime currently treats all client money as part of a single pool in the insolvency of an investment firm. However the proposals will allow firms, with their clients' agreement, to operate legally and operationally separate client money sub-pools (i.e. multiple pools). In considering the legal efficacy and robustness of the proposal for multiple pools it is important to consider:

3.1.1. the mischief that the proposal is intended to address;

3.1.2. how effective the implementation of the proposal will be in addressing that mischief; and

3.1.3. what possible legal and practical uncertainties the proposal, once implemented, will create in doing so.

3.2. Increasing the speed of the return of assets, reducing the market impact of an insolvency and achieving a greater return of assets are, the FMLC presumes, the chief objectives which a reform of client money rules will seek to address.

3.3. The complexity of relevant rules and the complexity of firms' systems and practical arrangements for implementing them, coupled with legal uncertainty and related litigation risk in respect of claims and assets on insolvency, are key factors militating against these aims.

3.4. The implementation of any proposal will necessarily, be evaluated according to whether it effectively reduces complexity and/or litigation risk. The comments below focus on legal and practical uncertainties in relation to the multiple pools proposal from this perspective.

Main rationale for multiple pools

3.5. When the existing UK client money regime was designed, the decision to have a single client money pool was taken after long consideration. It was believed that various policy objectives pointed towards use of a single segregated pool rather than multiple pools. A single pool was also considered more desirable from a legal certainty perspective because it was felt that it would reduce the risk of "tainting" a pool of trust assets with assets not related to the relevant trust.[15]

3.6. Multiple pools are now proposed, in the first instance, as a useful tool to support the porting of centrally cleared client positions, in the context of client omnibus accounts in particular. Problems concerning collateral in the context of omnibus client segregation are well known and the FMLC welcomes mechanisms which can effectively mitigate such problems. Some points to note in this regard are as follows:

3.6.1. **Timing** – Since porting will ordinarily need to take place in a matter of days following a broker default, any assets in a pool must be capable of distribution during that period in order to be truly helpful. If they are not, clients will still need to find new assets to collateralise their positions once ported.

3.6.2. **Client consent** – As noted at paragraph 3.9 of CP12/22, porting of a client omnibus account may well require the consent of all clients. It is likely that this would apply equally to the porting of any related pool, suggesting that the usefulness of the arrangement may be limited unless consideration is given to more active regulatory intervention to direct transfers (as one sees in the US).

3.6.3. **Operational issues** – A clearing broker may not have in its hands a segregated pool of collateral that corresponds to the "gross element" of client collateral supporting cleared positions. This may be because the broker is regulated as a bank, and therefore holds cash as banker. More importantly, in many cases, client assets sitting with a broker will not be held for a single purpose—there may well be commercially agreed cross-collateralisation/portfolio margining or other

15 The *LBIE* Supreme Court Judgment provides that a statutory trust is not bound by the normal English laws of trust and so its express terms may more effectively define its operation.

arrangements between broker and client which mean the assets are encumbered for other legitimate purposes. It might therefore be that any effective pool can only work for those clients of the broker who have not entered into alternative arrangements. A broker may have to carry more than one client omnibus account at a CCP (it may not, as a matter of CCP rules, be possible to do so) in order to differentiate between those clients for whom it holds a “fully funded” pool of collateral and those for whom this is not the case.

3.6.4. **Insolvency law implications** – Legal uncertainties may arise with respect to (i) dealing with the costs of administration generally; (ii) the question of whether clients avoid the need to contribute towards their share of administration costs on ported collateral; and (iii) whether an amount can be withheld by the CCP, in which case, there would still be a shortfall at the CCP level which would need to be addressed in terms of allocation amongst clients.

Further rationale for multiple pools

3.7. The rationale for facilitating multiple pools beyond that set out above appears to be the more general objective of better levels of client protection and flexibility. The FMLC takes the view that, in considering whether these outcomes will be delivered, it is important to address the following issues (amongst others) in terms of legal certainty:

3.7.1. **Complexity** – Multiple pool arrangements will undoubtedly increase the complexity of a firm's practical arrangements and the complexity of the related legal regime. The more pools are permitted, the more this is likely to increase.

3.7.2. **Compliance** – It is necessary to assess any regime not just in the context of full compliance but also in circumstances where a firm fails to comply with its obligations. With increased complexity, the likelihood of breaches by firms may increase and any regime must be robustly designed so that, even in light of that increased complexity, it is able to successfully respond to a situation in which a firm has failed in its compliance (as, for example, Lehman Brothers did).

3.7.3. **Supervision** – Any regime must be capable of effective supervision by relevant regulators so as to maximise the chance that material failings in compliance are promptly identified and rectified. A more complex regime may present challenges to delivering such effective supervision.

3.7.4. **Transparency** – A client is likely to expect some level of transparency as to the other participants in their pool so that it can better understand the nature of exposure which it is assuming in having assets in that pool. Perhaps more importantly, a client is likely to wish to know the risk profile of its traded positions. A tension, therefore, arises with regard to (i) obligations of confidentiality owed to clients and (ii) questions as to equal disclosure: which may be difficult to resolve satisfactorily in a trading context.

3.7.5. **Client choice and loss mutualisation** – Further to the point above, with more client choice sophisticated clients may seek very exclusive or even individual pools for their own business. The role of pools as a loss mutualisation mechanism between clients would, as a result, becomes more limited. If flexibility is extended to allow for very specific pools, this loss mutualisation mechanism may disappear and it will become more likely that circumstances will arise in which a particular constituency of clients faces large losses whilst others recover in full—through no fault of their own and even in circumstances of full compliance by the insolvent broker (i.e. if losses of another client in the relevant pool reduce the value of the pool as a whole).

3.7.6. **EU law** – The majority in the *LBIE* Supreme Court Judgment considered that the overriding purpose of MiFID was to give a high level of protection to all clients, not merely those for whom money had been actually segregated. CASS was read in light of that overriding purpose.

3.7.7. As noted above, where multiple pools are available which might allow the most sophisticated clients to get a materially better level of protection (possibly by having their own individual pool) and less sophisticated clients, or those with less commercial bargaining power, remain in residual pools which carry different risks, it must be considered whether the regime as a whole would comply with the purpose of MiFID as it is understood by the Supreme Court.

3.7.8. **"Fiduciary" obligations of the broker** – it is unclear whether the use of multiple pools imposes an obligation on a broker to ensure "fairness" in the constitution of pools and, if not, it is unclear as to the nature of its obligation to clients. The nature of such an obligation, which might arguably be fiduciary in nature, would be very difficult to define. In any event, a breach by a broker of an obligation of this type would likely only become the subject of dispute in its insolvency, increasing litigation risk and raising the question of whether any successful claims by clients for breach should be treated as protected client money claims (and if so, against which pool) or unsecured claims (which achieve no practical benefit for the client).

3.7.9. **Policy uncertainty as to where the loss falls** – While the FMLC does not wish to comment on the policy question as to where losses should fall, the Committee notes that the taking of a position on this question may be a necessary precursor to reforms of CASS. This decision will affect choices as regards the technical and legal structure of a reformed client monies regime.

3.7.10. The question as to where losses fall when (i) there is insufficient money in a particular pool to meet the claims of beneficiaries of that pool and (ii) clients have been incorrectly segregated or have not been segregated when they should have been goes to the heart of the debate on whether a CASS client money pool should be a trust asset for the benefit of actually segregated clients or a "compensation" pool (the view taken by in the *LBIE* Supreme Court Judgment) for all clients who should have been segregated.

3.7.11. This question takes on an additional dimension when one considers the allocation of the claims of unsegregated or undersegregated clients to particular pools. In smaller and more granular pools, the impact of possible additional claims in diluting the assets is exacerbated.

The statutory trust as a legal mechanism for delivery

3.8. If, as a matter of policy, it is considered desirable that multiple client money pools over and above those which are required for the purposes of clearing are introduced, the legal mechanisms for delivering such a structure will need careful consideration with a view to mitigating litigation risk.

3.9. As explained below, given the apparent flexibility of the statutory trust mechanism as interpreted in the *LBIE* Supreme Court Judgment, the drafting of the terms of the statutory trust per pool might be a useful mechanism through which to implement policy choices as regards the allocation of claims.[16]

3.10. The FMLC notes that, having a bespoke client money trust may be seen as constituting a privilege for the person or persons within it. Those wishing to set up such a pool can audit the records of the institution responsible for it in order to ensure that they have protection. If bespoke pools are indeed advantageous in this way, it may be deemed necessary to protect the rights of investors outside bespoke pools.

3.11. If this is correct, the statutory trust should be defined so as to preclude a bespoke pool from having constructive trust or traceable assets in the statutory trust. The bespoke pool would comprise only that which it is stated—in the records of the institution responsible—to comprise. Equally, claims on the assets of the pool will only be those which are recognised as

16 See paragraphs 4.5 and 4.6.

claims on the records of the institution responsible for the pool.[17]

3.12. If monies have not been placed into the separate account, or claims have not been recorded, this should not taint the effectiveness of the bespoke pool and should not delay the prompt return of assets to those for whom it was in fact segregated (based on the records of the institution responsible).

3.13. The FMLC notes that a policy choice will need to be made with regard to the position of assets which are mistakenly excluded from the separate pool—it is unclear whether they would form part of a general client money pool, a further recovery to the relevant bespoke pool wherever identified or the general estate—and as to the position of the unsegregated or undersegregated clients (i.e. those for whom the institution's records do not accurately reflect their claim against the bespoke pool). If clients in this position have no claim against the bespoke pool, the question arises as to whether they are left with a fallback claim against a general statutory pool or whether they are unsecured creditors. If a statutory pool is used as a fallback for such residual claims, this would appear to constitute a major dilution of recoveries.

3.14. The FMLC considers that if the issues discussed above are not carefully considered the result of creating multiple client money trusts may be to bring about more complex and lengthy litigation after the event.

4. PART 3 OF CP12/22 – CLIENT ASSETS REGIME: ACHIEVING BETTER RESULTS

4.1. Part 3 of CP12/22 addresses the issue of how the client money regime could be further improved in order to expedite the return of client money (and assets) on the insolvency of an investment firm.

4.2. The fundamental policy issue raised by this part of CP12/22 is whether the current rules strike the correct balance between the desire for clients to obtain

17 It is apparent from the proposed wording in CP 12/22 at CASS 7.10.11R and 7.10.12R that the FSA recognises the issues of uncertainty discussed in paragraphs 3.11 to 3.13.

a speedy return of their money and the need for accuracy. It is not for the FMLC to comment on the merits of the different policy options in this area. The following discussion considers, however, the legal uncertainty issues associated with policies to promote speed and/or accuracy of return.

4.3. CP12/22 refers to the material delays in returning client money experienced in the cases of LBIE which went into insolvency in September 2008 and MF Global which went into insolvency in October 2011.[18] There are two main reasons for these delays.

4.3.1. The failure by investment firms to comply properly with the FSA's client money rules has resulted in a shortfall in the funds available for clients and uncertainty as to whom funds should be distributed. The enhanced supervisory focus on client money that followed the collapse of Lehman Brothers has reduced, though not removed, risks arising from a firm's failure to comply with the existing rules. The issues encountered on the insolvency of MF Global, in a "post-Lehman" environment, demonstrate that these risks continue to exist.

4.3.2. Legal uncertainty concerning the CASS rules and the statutory trust have contributed to delays. Many areas of legal uncertainty have now been resolved through the litigation which followed the insolvency of LBIE and certain further issues are being considered in the litigation which has followed the insolvency of MF Global.

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18 Paragraph 4.15 of CP12/22 contrasts the position in the UK with that in the United States. The consultation notes that nearly all securities customers of MF Global Inc received 60% or more of their account value within a month of the firm's insolvency.

Sections 78fff-2(c)(3) of the US Securities Investor Protection Act 1970 (the "SIPA"), which deals with the liquidation of registered broker-dealers, provides customers with an entitlement to a priority for return of assets over general unsecured creditors. This priority only exists in relation to the net equity value of cash or securities that are deemed customer property under SIPA. The SIPA regime does not, however, confer on segregated clients the status of "super creditors" who have a priority over other creditors in respect of the shortfall in any customer property, although the Securities Investor Protection Corporation does guarantee customers payment of up to $250,000 per account with respect to a shortfall in customer cash and up to $500,000 per account with respect to a shortfall in customer securities. If such an equivalent regime was introduced in the UK it would permit an administrator to recover funds from the firm's house accounts or other account into which money was transferred, where the firm's segregated clients were entitled to that money. The insurance elements of the US regime are materially more generous than the UK equivalent. The distribution in the US MF Global insolvency was facilitated by a guarantee of several hundred million dollars provided by the CME which permitted the bankruptcy trustee to make early distributions of money. Accordingly, the speedier payment out of funds in the US insolvency process was not due to an inherent feature of US insolvency laws.

4.4. The clarification of legal uncertainties could contribute (along with improved compliance) to an improvement in the speed of return of money without prejudicing accuracy.[19]

The *LBIE* Supreme Court Judgment

4.5. As referred to in the Index of Defined Terms section at the front of this paper, in the *LBIE* Supreme Court Judgment the following three issues were considered in relation to the construction of CASS 7: (i) when does the statutory trust created by CASS 7.7.2R arise; (ii) do the primary pooling arrangements set out in CASS 7A apply to client money held in house accounts; and (iii) is participation in the notional client money pool dependent on actual segregation of client money. The *LBIE* Supreme Court Judgment dismissed the appeal by a majority from the decision in the *LBIE* Court of Appeal Judgment and held that:[20] (i) the statutory trust that applies to client money under CASS 7 arises upon receipt of the client money by the institution, and does not depend on the institution actually segregating the money; (ii) the client money pool available for distribution on an insolvency event is comprised of all funds being identifiable as client money, irrespective of which account the money resides in or was received by; and (iii) the client money pool is to be distributed among all clients having an entitlement, and that clients' entitlements are to be dependent on their respective contractual claims.

4.6. The decision by the Supreme Court to endorse the “claims” as opposed to “contributions” approach to the distribution of client money in the *LBIE* Supreme Court Judgment may contribute to delays in distributions in future

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19 The FMLC notes that a secondary market in claims exists so that clients (both client money clients and creditors) are able to sell claims and obtain a quicker return than through the insolvency process. Unsecured creditors of MF Global, for example, have been able to sell claims for around 85% or more of their value. The Joint Special Administrators estimate that the available funds could amount to between some $3.0 billion and $3.2 billion and total client money and unsecured claims could fall between some $3.0 billion and some $3.6 billion.

20 A brief description of the *LBIE* Court of Appeal Judgment is at the Index of Defined Terms section at the front of this paper.

insolvencies.[21] Office holders will be required to identify clients with valid "claims" to client money protections, as opposed to dealing with a more readily identifiable group of clients who can demonstrate that they have made a contribution to the client money pool.

4.7. CP12/22 suggests that the FSA is considering whether to establish a regime that, in contrast to the *LBIE* Supreme Court Judgment, places more emphasis on actual segregation and firms' records. The FMLC does not wish to comment on the policy underlying this approach but notes that the approach appears consistent with the requirements of MiFID which refers to the rights of clients to assets being kept distinct from the rights of the firm to assets (see Recital 26 of MiFID) and the need for firms to have adequate organisational arrangements to minimise the risk of loss or diminution of client assets. This approach would benefit clients whose funds have in fact been segregated but would prejudice the position of clients with a claim to client money protection, but whose funds have not in fact been segregated. Such clients could prove as unsecured creditors.

4.8. It appears that under the *LBIE* Supreme Court Judgment all identifiable client money, wherever held, should be brought into the client money pool. Again, this approach could create operational uncertainty because it may cause material delay, given that office holders will have to carry out an analysis of the firm's house accounts to identify client money that has not been transferred to the client accounts. On the other hand, clients whose money is held outside the client accounts could pursue their own tracing claims.

4.9. CP 12/22 notes that the FSA is considering the approach taken in some jurisdictions whereby an office holder may liquidate all assets and clients all share in the shortfall (both client money and custody assets) equally. However, delays in recent investment firm insolvencies have not been caused by the separate treatment of client money and client assets and so it is not

21 It should be noted that in the "claims" approach the basis for a client sharing in the client money pool is the amount of that client's money which ought to have been segregated, whereas, in the "contributions" approach the basis for a client sharing in the client money pool is the amount of that client's money which was in fact segregated.

clear that there is any need to pool and share losses between client money and client asset clients. It is noted that, expediting the return of money to clients will entail greater resources and the incurring of greater costs. These costs of distribution are likely to fall on the cash and assets being distributed and not on the firm's general estate. Accordingly, this may result in some dilution of funds available to be repaid to clients.

Proposals to reduce the market impact of the insolvency of a firm that holds client assets

4.10. Box 3 on page 44 of CP12/22 sets out a proposal to dislocate the primary pooling event from default:[22]

> Allowing the [Insolvency Practictioner] to have the option not to constitute the client money pool and distribute client money and custody assets immediately, will potentially allow the [Insolvency Practictioner] to sell the business post failure so that clients could be less affected by the failure of the firm as their business would continue as normal.

4.11. Because the funds held in the defaulting firm's client accounts are beneficially owned by the firm's clients, an office holder will not simply be able to transfer these to a new solvent firm without the express consent of clients or directions from the court.[23] The FMLC acknowledges the suggestion in Box 3 (page 44 of CP12/22) that it may be made possible for clients to provide consent in advance.

4.12. It is the FMLC's view that further consideration will need to be given to the legal issues that may arise from dislocation and delay the transfer of client funds.

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22 Under the current CASS rules, the failure of an investment firm triggers a primary pooling event in which all client money is pooled for distribution.

23 A new solvent investment firm may also be reluctant to accept the transfer of client funds where there is a shortfall or where there is uncertainty as to the completeness and/or accuracy of the records of the firm from which the funds are to be transferred.

4.13. Box 4 on page 47 of CP12/22 suggests that a greater return of client money could be achieved by requiring firms to hold a “buffer” in the client account in order to meet the costs of the officeholder in distributing client funds and/or potentially losses arising on the firm’s failure. A similar proposal is to require a firm to effect insurance to cover such costs and/or losses.

4.14. The FMLC has been given to understand that client money applications before the Courts have considered whether funds from the general estate could be used to “top up” client funds where there is a shortfall. Various arguments under trust law have been advanced to support this approach but these have been rejected. In principle, a mechanism for "topping up" losses or shortfalls can be expected materially to expedite the process.

4.15. On the insolvency of a firm the use of the buffer and/or insurance exclusively for the benefit of segregated clients might face challenges by the unsecured creditors since both would involve the use of the firm's own money to fund a particular class of client/creditor. Accordingly, the FMLC notes that appropriate changes to the law would be needed in order to preclude such challenges.

4.16. CP12/22 also refers to the use of the Alternative Approach.[24] This approach does create material risk to clients. It is also not expressly provided for under MiFID and therefore arguably not compliant with MiFID requirements in any event.

5. CONCLUSION

5.1. The FMLC believes that consideration and clarification of the points raised above is important for the creation of a robust and predictable client money regime which provides legal certainty to the wholesale financial markets.

24 As defined at CASS 7.4.14. G.

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