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Briefing note March 2012

The Lehmans Supreme Court Judgment and Client Money: Further Reflections

Now that the Supreme Court has given its judgment on certain issues concerning client money held by Lehman Brothers International (Europe) Limited ("**LBIE**") at the time its administration proceedings commenced[1] , we seem to have some clarity on the application of the CMR[2] to client money held by a firm in the context of MiFID business where such firm is insolvent. However, as indicated by the fact that the conclusions on two of the three issues were only determined by a majority of three to two, the issues are not clear-cut. Moreover, the points regarding which there is now a clear ruling are likely to give rise to further questions.

Reading the judgment is not helped by the fact that the CASS references relate to the version of the CMR applicable to LBIE, namely the CASS chapter which prior to 1 January 2009 applied to client money held in the context of MiFID business. The current CMR apply to client money held by a firm, whether such firm is conducting MiFID business or non-MiFID business . In general, the text of the client money rules referenced in the judgment is substantially the same as the text of the current CMR provisions applicable to MiFID business , but there are some points of concern, as discussed below.

Key issues

- All client money is held by the firm subject to the client money trust from the time at which the firm receives that client money.
- Pooling of client money on the insolvency of a firm will involve not just money held in accounts identifiable as client money accounts, but also any money in house accounts which can be shown to be client money.
- Insolvency officials must distribute all client money among all clients for whom client money was received into the client money accounts and house accounts
- What does this mean for the operation of house accounts, and non-MiFID business

[1] *In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2012] UKSC 6, 29 February 2012*

[2] *For the purposes of this note, Chapters 7 and 7A of the Financial Services Authority ("FSA") Client Assets sourcebook ("CASS")*

What do we know now?

When is client money held on trust?

To determine when a firm holds client money on trust, the judgment refers to CASS 7.7.2R and the meaning of "client money" in CASS 7.2.1R[3]. The conclusion is that all client money is held by the firm subject to the client money trust from the time at which the firm receives that client money. It is not the case that client money is subject to the trust only when paid into a separate client money account maintained by the firm in accordance with the CMR.

As a result, whether a firm uses the alternative approach[4] or not, and whether as a systems matter the money passes through other accounts before being credited to a client money account, the firm holds client money on trust from the moment of receipt, and the terms of such trust are the provisions of the CMR.

What is a client money account when pooling?

In CASS 7.9.6R(1)[5], where it is stated that "client money held in each client money account of the firm is treated as pooled", the judgment concluded that the phrase "each client money account" is to be interpreted as meaning any account of the firm into which client money has been paid. As a result, the pooling of client money on the insolvency of a firm will involve not just money held in accounts identifiable as client money accounts, but also any money in house accounts which can be shown to be client money.

Which clients share in the pooling?

CASS 7A.2.4R(2) states "the firm must distribute that client money in accordance with CASS 7.7.2R, so that each client receives a sum which is rateable to the client money entitlement calculated in accordance with CASS 7A.2.5R." The majority judgment concluded that for the purposes of this rule, "each client" means each client who has deposited money with (or on whose behalf money was received by) the firm and who therefore has a claim to have such money held as client money subject to the CMR.

The result of this is that, on the insolvency of a firm, the insolvency officials must identify all client money held in house accounts (which may involve tracing claims) then pool this with the money in identifiable client accounts, and distribute all such money among all clients for whom client money was received into the client money accounts and house accounts. This will of course be a complex and time-consuming calculation. However, another possibility would have been equally complex, namely a two tier system where the insolvency officials identify (i) the clients for whom money was actually received into the accounts identified as client money accounts and distribute that money among those clients only, and (ii) the clients whose money was received into house accounts but should have been held as client money therefore is subject to a trust and in respect of which such clients may exercise tracing claims.

Based on this conclusion, CASS 7A.2.6G (formerly CASS 7.9.8G) is not completely correct. This Guidance states "A client's main claim is for the return of client money held in a client bank account . A client may be able to claim for any shortfall against money held in a firm's own account. For that claim, the client will be an unsecured creditor of the firm." However, the judgment has shown that to the extent that client money is held in a firm's own account, such money will be included in the pooling and allocation under the CMR. It is of course still likely that, in the insolvency of a firm, a client will receive a distribution of client money which is less than the client money originally received and held by the firm for that client (for example, due to insolvency of banks with which client money was held or deduction of distribution expenses), in which case the client will have a residual unsecured claim against the firm.

Other issues

Other points noted in the judgment were that:

- it is the duty of the insolvency officials to carry out a final reconciliation in relation to client money as at the time of the commencement of the insolvency;
- pursuant to CASS 7A.2.7R (formerly 7.9.9R), the client money entitlement of each client is to be

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[3] *Now deleted but the definition inserted in the FSA Glossary is in substantially the same form as it relates to MiFID business: "money of any currency ... that a firm receives or holds for, or on behalf of, a client in the course of, or in connection with, its MiFID business"*

[4] *See CASS 7.4.14G to 7.4.19G*

[5] *Now CASS 7A.2.4R(1), the wording of which is, aside from a change in cross-referencing, identical*

calculated as at the time of the commencement of the insolvency;

- there is no indication in the CMR that a firm has an obligation to make good a shortfall in client money.

What are the implications?

When is cash actually received by a firm?

The conclusion as to when the CMR trust applies to client money is likely to focus attention on the practical question of when a firm actually receives or holds cash "for or on behalf of a client". For example, where a firm holds money which it has received for its own account but some or all of that money becomes due to the client, does the amount due to the client simply constitute a contractual claim for payment, or should such money be regarded as received or held by the firm for the client? If the latter, then cash becomes subject to the obligation to segregate and should be regarded as client money even though held in a house account. This situation could arise if clients provide cash margin to a firm on a title transfer basis but the firm is subject to an obligation to repay excess margin.

It is important to note that the judgment of the Supreme Court has not answered this question. The judgment distinguishes between clients with contractual claims, and clients who had made contributions, but this distinction must be viewed with care, because the analysis in the judgment shows that "contractual claims" in this context refers to the contractual claim to have client money segregated, rather than a contractual claim for payment. The terminology is therefore somewhat misleading, because in practice the distinction is between two types of client who have made contributions of client money, namely those whose client money was credited to a client money account and those whose client money was credited to a house account. The judgment does not indicate that clients of an insolvent firm who were simply owed amounts by the firm are entitled to share in the client money pool to the extent of their unsecured contractual claim.

It should be noted that, although the judgment is concerned with the alternative approach where client money can be paid into the firm's house account, even under the normal approach a firm is required to pay client money "promptly, and in any event no later than the next business day after receipt" into a client bank account. Consequently, without the judgment's conclusion regarding the application of the CMR trust, even under the normal approach there would be potential risk to clients to the extent that client money had been received but not paid into a client bank account before the commencement of insolvency.

What does the Supreme Court's conclusion mean for the operation of house accounts?

Given the conclusion regarding the point from which client money is subject to the CMR trust, it seems logical that the judgment should decide that all client money, even if held in a house account, should be included in the client money pool to be distributed to clients in accordance with the CMR. However, this does raise various questions.

CASS 7.3.1R requires that "A firm must, when holding client money, make adequate arrangements to safeguard the client's rights and prevent the use of client money for its own account." If "client money" now includes money received from or on behalf of clients and paid into a house account, this suggests that firms may need to take additional steps to demonstrate "adequate arrangements" to safeguard the rights of clients to money in the house account and prevent use of such money for its own account.

As is noted in the judgment, there is no requirement in the CMR that a firm should obtain from banks with which the firm holds its own money an acknowledgement that the house account may contain client money and that the bank must limit its set-off rights accordingly, but does the meaning given to "client money" mean this would be advisable?

It is unclear how the holding of trust monies in a house account with a bank will affect the rights of set-off which such bank may have in respect amounts due to it from the firm. Moreover, in the particular circumstances of claims against LBIE, it is unclear whether there will be any challenge by the administrators in respect of set-off rights already exercised in respect of house accounts to the extent such accounts are regarded as having contained client money.

In the first instance judgment it was not disputed that client money accounts include client transaction accounts

(broadly, accounts with an exchange, clearing house or intermediate broker , in which client money is held in the circumstances permitted by the CMR – see CASS 7.5). Is there now a risk that a firm's own money passed to an exchange, clearing house or intermediate broker could be regarded as client money (even if this conflicts with the firm's obligations to the relevant exchange, clearing house or intermediate broker)?

Where money held in a house account is in fact money held on trust, to what extent should (or can) the trust money be identified and taken into account for balance sheet accounting purposes or capital adequacy calculations?

Notwithstanding the willingness in the judgment to conclude that normal trust law does not apply to a CMR trust, it is surely still the case that certainty of subject matter of the trust is essential. While commingling trust monies with own funds in a house account is not necessarily inconsistent with the existence of a trust, it is difficult to see how money can be shown to be held subject to the client money trust if it is not possible to identify which money is subject to the trust (i.e. in this context, which of the money paid into the house account was money received on behalf of or for the account of a client). It seems likely that a complex forensic accounting analysis will be necessary in order for the LBIE administrators to identify the extent of the money in house accounts which should be regarded as client money.

How should firms now interpret the CMR in relation to non-MiFID business?

In reaching the final conclusions, considerable weight was given to the fact that CASS Chapter 7 was created to implement MiFID[6] and the MiFID implementing directive[7], and therefore various determinations were made on the basis of what the draughtsman must have had in mind when drafting the relevant text. In practice, the text of CASS Chapter 7 was very similar to what was at the time the non-MiFID CASS Chapter 4, both of which were substantially similar to the client money rules in existence before the amendment of the FSA rule to implement MiFID. The judges in their decisions in the Supreme Court evidently concluded there was considerable freedom to override or ignore the text of the client money rules to the extent incompatible with the overall purpose of compliance with the aims of MiFID. As a result, it is debateable whether, if similar issues were to arise in relation to the application of the CMR in the context of non-MiFID business, a different result would be reached, or whether it is safe to conclude that the similarity of the client money rules would mean the same reasoning would apply. This would seem not unreasonable for the purposes of consistency, although strictly speaking would be an odd result: it would mean that text which was, in reality, substantially drafted long before MiFID, has been construed (and where considered necessary amended) as if drafted for the purposes of MiFID compliance, and such interpretation would then be applied to effect application of rules never intended to apply in a MiFID context.

Conclusions?

It seems unarguable that there have been, and will continue to be, significant complexities in resolving the details of the LBIE client money calculation and distribution process. Although there is now some clarification regarding the interpretation and application of the CMR, it seems likely that the follow-up to such clarification will involve a lengthy tracing process in respect of client money held in house accounts and increased focus on the set-off rights of banks.

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[6] *Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments*

[7] *Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC*

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