

## Client money protection after the Lehman case: Testing the limits and limitations of the FSA's rules

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"...There has... been a falling short in the achievement of both of those objectives [separation of firm's and clients' money and repayment in full of the latter] on a truly spectacular scale."

(Mr Justice Briggs<sup>1</sup>)

Extensive and expensive legal argument over the FSA's client money rules and their application to the Lehman Brothers administration in the UK is set to continue before the appellate courts in the months to come.

This paper does not attempt to predict the ultimate outcome of that litigation. Instead, it highlights some key overarching legal principles at the heart of the difficult issues which the courts have had to consider, the interaction of which will be key to the eventual resolution of the substantive issues:

- The requirements of applicable EU legislation (in this case, the Markets in Financial Instruments Directive or MiFID), with its potential to change dramatically the way in which the English courts approach the task of interpreting domestic legislation and rules (in this case the CASS 7 client money rules made under FSMA).
- The scope of the carefully constructed equitable remedy of 'tracing', where a person acting as trustee (such as Lehman Brothers was acting in respect of its clients' money) has wrongly mixed trust monies with its own.
- The principle of *pari passu* distribution in an insolvency, which leans against preferring any creditor over another unless the creditor falls clearly within an express exception recognised at law.
- The extent of the FSA's existing powers under FSMA to make rules modifying the application of English law in those two critical areas.

Finally, this paper considers the statutory powers that the FSA does presently possess which could enable it to improve the operation of CASS 7, without prejudice to the final decision of the appellate courts in the *Lehman* case, and what other responses are being, or might be, considered to address what is admitted on all sides to be a glaring deficiency in client protection.

### The facts

Put shortly and bluntly, the factual issue concerning client money in the UK administration of Lehman Brothers International (Europe), LBIE, is that the claims of those parties who allege that Lehman held or should have held their money as client money has exceeded by a huge amount the money *actually* held in the clearly segregated client money accounts of the firm.

On any view of the matter, Mr Justice Briggs was surely correct when he characterised this state of affairs as a "*spectacular failure*" to ensure the protection mandated for client money by MiFID, as implemented by the FSA's client money rules.

<sup>1</sup> In *Lehman Brothers International (Europe) v. CRC Credit Fund Ltd & Ors* [2009] EWHC 3228 (Ch)

Three main reasons are cited for the huge discrepancy between the client money claims on LBIE and the undisputed client money actually held by the firm:

- An alleged outright failure by LBIE to recognise and treat funds which it was holding for clients as client money, especially when those funds were received from affiliates of LBIE. The shortfall of funds held in this way, if all relevant claims are established, exceeds US\$3 billion.
- The insolvent failure of an affiliated bank in Germany, with which LBIE had deposited over US\$1 billion of undisputed client money. The client money regime does not, and is not intended to, protect against the failure of the bank at which an investment firm maintains its segregated client money account, although this may have come as something of a surprise to some LBIE clients.
- The effect of the "alternative approach" to client money segregation, permitted by the CASS 7 rules, whereby client money is both received from and paid out to clients from a firm's general bank accounts, with internal reconciliations being conducted every business day to establish what money needs to be transferred to or from the properly segregated client money accounts. In the case of LBIE, significant amounts of client money entered its general bank accounts after the last reconciliation with the segregated accounts but before the onset of administration (i.e. before further reconciliation and segregation could occur), thus exposing a serious flaw in a doubtless common practice among investment firms.

## The High Court judgment

Faced with a tidal wave of client money claims and a client money balance that could patently not satisfy those claims, the administrators sought to find a practical legal means of resolving the situation by submitting to the Court an agreed but assumed statement of facts to give the judge a basis for an attempt to clarify the application of the law. (The assumed nature of the facts means that the parties are free to contest the facts in future proceedings if they see fit.)

In summary of the central elements of the judgment, the judge found that:

- Only money held in truly segregated client bank accounts is ring-fenced from the assets available to satisfy the general body of creditors (and therefore protected as client money).
- Money which *should* have been segregated as client money but was *not* so segregated could potentially be traced by the beneficiaries into the firm's general accounts under English law principles of equity, but in the circumstances this remedy is unlikely to be a worthwhile exercise.
- The firm (acting through its administrators) is not obliged to 'top up' client money accounts from the firm's general bank accounts, to the detriment of the general body of creditors, so as to eliminate any shortfall.
- Only those clients whose money *was actually* segregated in the client bank accounts could claim against the resulting client money 'pool' which came into existence at the onset of administration (i.e. those clients whose money *should* have been in the pool but was not are unable to claim against the client money pool).

## Overarching legal principles

### *The primacy of EU Law*

The relevant EU Directive pursuant to which client money rules are required to be made in each Member State is the Markets in Financial Instruments Directive, or MiFID. As the judge at first instance said in the *Lehman* case, it is now settled law that:

*"...domestic legislation such as CASS 7 which is made for the purpose of fulfilling the requirements of EU law contained in a Directive must be interpreted in the light of the meaning and purpose of the Directive. For that purpose the court may need to adopt a two stage approach, the first of which consists of interpreting the Directive, and the second of which consists of interpreting the domestic legislation in the light of the meaning of the Directive, thus interpreted..."*

The judge concluded that this second stage involves an extremely purposive approach to interpretation, constrained only by the requirement that a court must not "*cross the boundary between interpretation and amendment*" and that the court should not "*make decisions for which it is not equipped, or give rise to important practical repercussions which the court is not equipped to evaluate*".

On this approach, were it the case that MiFID had obliged Member States to ensure that clients' money is protected on a firm's insolvency, then it might be that rules such as those in CASS 7 should properly be interpreted so as to achieve this end; if necessary, overriding longstanding tenets of English property and insolvency law.

So there is a crucial question: what is it that the MiFID requires of Member States in respect of client money protection?

The basic requirement of MiFID (amplified in detail by its Level 2 implementing Directive – which may not however enlarge the scope of the primary Directive's provisions) is that a Member State shall "*require that investment firms comply with the organisational requirements set out [in the Directive]...*", among which is the organisational requirement that:

*"an investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the clients' rights and, except in the case of credit institutions, prevent the use of client funds for its own account."*

The judge in the *Lehman* case held that MiFID's emphasis on a firm's organisational requirements means that it is ultimately up to firms themselves to secure that client money is protected, for example by complying with relevant regulations, and that MiFID neither expressly nor impliedly requires changes to be made or implied to English property and insolvency law. On the contrary, as the judge put it, the Directive takes such law "*as it finds it*".

An alternative approach to interpreting the impact of MiFID could have been to acknowledge that there is an overarching purpose in the Directive to achieve investor protection, including protection of client money, and therefore what is required is an interpretive approach to CASS which delivers this objective. If that or a similar approach is preferred by the appellate courts, a very different practical and legal outcome could result.

### ***The equitable remedy of tracing and the pari passu principle in insolvency***

As a result of his finding as to the effect (or perhaps non-effect) of MiFID, the judge considered himself constrained by precedent in considering what remedy is available to those clients of LBIE whose money, in breach of the terms of the statutory trust created by CASS 7, was mixed with the firm's own money in its general bank accounts and not treated as client money. He accepted that the equitable doctrine of 'tracing' could aid a client in those circumstances, although noted that the doctrine had been carefully confined in its scope by judicial authority. The judge summarised the law on this point as follows:

*"the unsegregated clients must identify their property (outside the segregated accounts) by the established techniques of tracing, and may seek to appropriate a proportion of any mixed account to their proprietary claims by means of an equitable charge only if they can trace their property into that mixed account ..."*

The first instance judge went on to confirm in his judgment that English insolvency law clearly distinguishes (and is not overridden in this respect by MiFID) between distributions to *contributors* to a fund to which they can assert a proprietary claim in priority to other creditors and distributions to other unsecured creditors. Clients who could only assert that their money *should* have been part of the client money fund (but who were not contributors) fell into the latter category.

It had to be acknowledged, therefore, that because LBIE's general bank accounts had included accounts which were overdrawn, and accounts which were reduced to minimum balances by regular cash sweeps into the US parent company's account, in the circumstances the tracing remedy was unlikely to provide any real prospect of protected recovery for LBIE clients, and in the absence of a tracing remedy those clients could not pursue their claims against a client money fund in which they had no interest.

To reverse Mr Justice Briggs's finding on these points would require an appellate court to find a sharper edge to the requirements imposed on Member States by MiFID the effect of which would be to override domestic law – unless of course it were held that the first instance judge (leaving aside any Directive requirement) has interpreted existing English law incorrectly.

### ***Rule-making powers of the FSA***

The client money rules in CASS 7 are made under the FSA's general rule making powers provided by the Financial Services and Markets Act 2000 (FSMA) for the "*purpose of protecting the interest of consumers*" (in this context "*consumers*" means those who "*use, have used, or are or may be contemplating using, any of the services provided by [firms]*".)

The only express mention in FSMA of client money rules which are relevant to the LBIE situation, and which are reflected in CASS 7, is the power to "*make provision which results in... clients' money being held on trust in accordance with [CASS 7]*" and the power to make rules pooling client money in the event of a firm's failure.

Again, absent legal impetus from MiFID, it would seem that (as the first instance judge has held) the FSA's rules may not currently modify the application of English property or insolvency law except to this limited extent.

The above are some of the important areas of EU and domestic law to be navigated in the appeals which are now expected to follow in the *Lehman* case. As will become apparent from this discussion, a key factor (perhaps the key factor) in the eventual outcome of the *Lehman* case will be the appellate courts' view of the force of MiFID and whether, in the interests of investor protection, European law requires the court to imply modifications to some hallowed and longstanding tenets of English law in the particular area of client money.

### ***The deficiencies of CASS 7 and the response of the UK authorities***

In reaching his substantive conclusions Mr Justice Briggs identified numerous gaps and deficiencies in the CASS 7 rules. One feature that he commented on was the 'one size fits all' nature of the regime. The client money regime was crafted with firms of a relatively straightforward nature in mind, perhaps because the events which have led to the rules being tested in relation to an institution such as LBIE were beyond the expectations of even the most prescient and cautious of rule-makers.

Nevertheless they are rules which should equally have been capable of being applied to huge and complex institutions such as LBIE, but when tested in that regard were found ultimately to be deficient in achieving the purpose of protecting clients' funds.

So under the FSA's current rule-making powers, could anything more have been done, or could more now be done, to address those deficiencies which contributed to the LBIE client money shortfall?

- The firm's alleged failure to identify funds received from or held for its clients as client money clearly cannot be cured by making a new rule. Rather it must be a matter for the regulator to police more closely (and perhaps therefore more intrusively) a firm's client money controls and its internal organisation and compliance systems. This is of course already on the agenda of the FSA, which has recently signalled general concerns around the handling of client money as well as its intention to regulate this area more closely (*Client Money & Asset report*, January 2010<sup>2</sup>).
- The FSA could amend the existing provisions of CASS 7 to prohibit or limit the use of affiliate banks to hold a firm's client money, on the grounds that if a firm or its group is in financial trouble, it is likely that the affiliate bank will also be affected.
- As to what the judge called the "black hole" created by the provision in CASS which allows for the "alternative approach" of a firm "temporarily" mixing client money with the firm's own money in its general bank accounts, it is clear that CASS could make provision for much tighter restrictions on the use of such money whilst it is held in that general account (currently there appear to be none – which may be contrary to what MiFID requires).
- The judge in the *Lehman* case suggested two possibilities for improving that situation: (i) that a firm should always maintain a credit balance on any general bank account which holds client money temporarily which is at least equal to the client money contribution; or (ii) that an equivalent sum of money be kept in a segregated account. The judge conceded that there could be practical difficulties with either method but did not consider them to be insurmountable.

Leaving aside the possible findings of an appellate court as to the potency of MiFID, it seems that primary legislation would be required if, as a policy matter, clients whose money should be segregated but is in fact not segregated are to be protected ahead of the general body of creditors on a firm's insolvency.

The Government consultation document on *Establishing resolution arrangements for investment banks* of May 2009<sup>3</sup> does not canvass the possibility of giving the FSA such powers, although it was published before the first instance decision in the *Lehman* case with the Government stating that it was following the proceedings "with interest".

There is currently an opportunity for the Government to legislate new powers for the FSA in this area, in the form of the Financial Services Bill. As yet, though, there is no sign of any such proposals to enhance the reach of client money rules through that Bill, and indeed there is now a question as to whether the Bill will in fact pass through Parliament before the general election. So perhaps a legislative solution is unlikely at this stage.

#### ***Postscript – the misleading notion of money being 'in' a bank account***

The remedy of tracing, much discussed in the *Lehman* case, as mentioned above, relies in part on the notion of a beneficiary's money being wrongly 'in' an account of the trustee, as if it retains some separate identity therein. Notwithstanding that the remedy of tracing operates as if this is the case, the legal reality is that an unsegregated general bank account maintained by a firm is an undivided asset of the firm (a debt owed to it by its bank) or, indeed, an undivided liability if overdrawn. It is not possible to identify a client's funds within that account.

This 'legal reality' has the effect that the notion of protected client money is even more misleading when a firm receives funds from a client (or owes funds to a client) but has not yet placed those funds in a segregated client bank account on behalf of the client (or paid them over to the client).

<sup>2</sup> [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>3</sup> [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)

Accordingly, as was confirmed both in the *Lehman* case and in an earlier case which addressed the UK client money regime (*Global Trader*<sup>4</sup>) a firm does not as a legal matter 'hold' money on behalf of its client (and therefore subject to the CASS 7 trust) at this point. Rather the firm at that point owes a contractual debt to its client.

A contractual debt being a liability of the firm, it is not an asset which could be the subject matter of a trust under CASS 7 or otherwise. It is only when the money is in fact paid into a segregated client bank account that it becomes an asset of the firm (a claim on the bank which 'holds' it) which is capable of then being subject to the CASS 7 trust.

Accordingly, clients whose funds have been received by a firm but not yet deposited into a client money account at a bank are merely owed a debt by the firm and consequently remain unsecured creditors of that firm. No trust has arisen at that stage, even though the client would have benefited from client money protection had the firm deposited those funds into a client bank account before insolvency.

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<sup>4</sup> *Re Global Trader Europe Ltd (in liquidation)* [2009] EWHC 602 (Ch)