UK client money protections after the Lehman litigation
The issues resolved and the problems that remain

This paper is an expanded version of an initial briefing we published on 2 March 2012, in which we summarised the decision of the Supreme Court in the Lehman Brothers case¹ concerning the treatment of monies held by the UK investment bank for its clients. In this paper we look at the way the legal analysis in the case developed and the implications for the FSA's Client Assets sourcebook (CASS), for the clients of Lehman in particular and for investment firms in general.

A RECAP OF THE KEY FACTS

The key pertinent facts of this case are, put briefly:

• When Lehman Brothers collapsed in September 2008, the claims of the clients of its UK investment bank, Lehman Brothers International (Europe), which alleged that their money should have been held by the firm as client money (and thus ring-fenced from the claims of the firm’s general creditors), exceeded by a huge margin the money actually held in the segregated client money accounts.

• Those claiming a right to client money fell broadly into three categories:
  – Those whose money was held in segregated client accounts (although over US$1 billion of that money had been deposited with a Lehman affiliate bank in Germany which was itself insolvent).
  – Those whose money would have been segregated by the firm but for the fact that at the time that the firm entered administration the money was temporarily held in its general bank accounts (a situation permitted under the “alternative approach” provided for in the CASS rules) and frozen thereafter.
  – Those (in particular, a number of Lehman affiliates) whose money should have been recognised and segregated as client money in accordance with the CASS rules, but was never recognised and treated by the firm as such.

¹ In the matter of Lehman Brothers International (Europe) (In Administration) and in the matter of the Insolvency Act 1986 [2012] UKSC 6
THE SUPREME COURT DECISION – WINNERS AND LOSERS

The end of this particular stretch of road has now been reached with the Supreme Court’s decision, published on 29 February.

The journey has not been straightforward and, on two of the three questions which it fell to the Supreme Court to decide, the division of opinion between the majority (three justices) and the minority (two justices) was stark and, at times, vociferous. That the drafting of the CASS rules could cause so much judicial division is indicative of their crucial ambiguities.

Nevertheless, judicial opinion, however divided, has produced what is for the time being a definitive interpretation of those rules, as follows:

• The statutory trust over client money which arises by operation of the CASS rules arises on receipt of the funds from a client, rather than at the moment of their segregation from the investment firm’s own accounts (all judges, from the High Court through to the Supreme Court, agreed on this principle).

• The client money pool which is created immediately upon the failure of an investment firm, as provided for by the CASS rules, includes not only those monies actually segregated in client money accounts, but also monies which are identifiable as client money but which were held at the relevant moment in the firm’s own (unsegregated) accounts (this was the view of the majority of the Supreme Court justices).

• Those clients who may submit a claim against the pool of client money thus enlarged include all of those clients who, as against the failed investment firm, were entitled to have their money treated as client money regardless of whether their money was in fact segregated or can in fact be identified in the firm’s own accounts as having been so segregated (another majority decision, although hotly contested by the minority).

There is, of course, a finite pool of money to be distributed by the administrators, and so whatever decision the Supreme Court reached it was inevitable that it would benefit some claimants at the expense of others. The ‘winners’ in legal terms were:

• Those clients whose money was, in accordance with the alternative approach permitted by the CASS rules, held temporarily in Lehman’s proprietary accounts prior to being segregated, with the expected segregation having been thwarted by the onset of insolvency.

• Those clients (principally Lehman affiliates) whose money should have been dealt with as client money but which the firm failed to recognise and treat as such.

The ‘losers’ were those whose money was in fact held in segregated client money accounts at the onset of insolvency and so formed the pool of client money from which the administrators are required to make distributions. That pool of client money (as enlarged by the Supreme Court’s decision) must now be shared with the two classes of ‘winners’, pro rata to each such client’s entitlement.

The ‘losers’ also include the general creditors. Money in the house accounts which might have been available to meet their claims will, if identified as client money, be moved to form part of the client money pool.
CASS 7 – THE DIVISIVE AMBIGUITIES

In our briefing paper of August 2010 on the earlier Court of Appeal judgment in this case, we identified the key ambiguities in the relevant rules on client money set out in chapter 7 of CASS (CASS 7), and distinguished the two opposing approaches to making sense of them. We called one approach "sceptical" and the other "generous".

Sceptical – because this approach proceeds on the premise that the CASS rules were drafted for a simpler world which did not include complex international investment banks; the contingencies and failings brought to light in the Lehman case were just not envisaged.

Generous – because this approach proceeds on the basis that the CASS rules must be shaped by an interpretation which best accommodates the circumstances at hand, and in particular with the aim of securing appropriate protection for the greatest number of clients.

The struggle between these two approaches continued in the Supreme Court.

The key ambiguities in the CASS 7 rules, and the different approaches to resolving them, can be summarised as follows:

- The rules provide that money held in "client money accounts" is to be pooled immediately upon the failure of an investment firm. These accounts are not further defined. The sceptical view held that the term was a loosely-drafted generalisation for the various categories of segregated client money accounts mentioned in the CASS rules. The generous view held that the term should be read to mean any account which, as a matter of fact, contains identified client money.

- The rules provide that money in the client money pool is to be distributed to "clients" (scope unspecified) according to their "client money entitlement" (again undefined). The sceptical approach held that the clients to whom this pooled money is to be distributed are those whose money is actually in the pool, and that the "entitlement" refers to each client's pro rata share after netting out possible negative and positive balances. The generous approach held that "clients" so "entitled" should be read to include any client who, as against the firm concerned, can establish that it had a right to have its money treated as client money.

The sceptic's points

The sceptical approach, which was rejected by the Court of Appeal as well as the majority in the Supreme Court, undoubtedly had several legal and practical merits:

- It read the CASS 7 rules as assuming compliance by the firm – that is, it assumes that money had by and large been held where it was supposed to be held when the firm failed. (There are no rules that seek to address the complications of non-compliance by the firm: see our further comments below.) There is therefore no escaping the gaps which appear when there is material non-compliance by the firm.

- It sits more comfortably with the traditional tenets of English trust law which provide that those with a proprietary interest in money would be protected only if both a trust is declared over that money (in this case by application of the CASS statutory trust rule) and the money is in fact properly segregated from the trustee's...
own funds. It can be assumed that the mechanism of English trust law was the means chosen by the UK to implement the relevant European Directive requirement (MiFID\textsuperscript{3}) that clients’ funds must be protected.

- The effect of the generous approach is to constitute the client money pool as, in effect, a compensation fund for clients whose money had been dealt with incorrectly by the firm, at the expense of those clients whose money had in fact been properly segregated for their protection. This represents a “cataclysmic shift” of the beneficial interest in that money, to use a phrase coined by Lord Walker when expressing the dissenting view in the Supreme Court. The sceptical minority felt strongly that clients who had ensured that their money was properly segregated should not be taken to have accepted that their protection would in fact be so precarious.

- Section 139 of the Financial Services and Markets Act 2000, which gave the FSA power to make the CASS rules, provides that the FSA may make a rule which “treat[s] two or more accounts as a single account” for distribution purposes. Arguably, this does not allow the FSA to make rules providing for the pooling of some of the money in one account (in this case the firm’s general account) with all of the money in another account (in this case a segregated client account), although this point appears not to have been much considered by any of the courts hearing this case.

The ‘benevolence’ of judicial interpretation
The generous approach which prevailed in the Supreme Court’s decision is markedly different. Whilst conceding, as did all judges in this case, that “textual assistance” from the relevant CASS 7 rules was “limited”, this approach gave a meaning to the rules which imputed a retrospective intention to the draftsman of CASS that his drafting should take account of Lehman-like contingencies.

As we noted in August 2010, the sceptical approach would have had the effect that when a firm opted to use the alternative approach allowed for by CASS, its clients were less protected than they would have been had the firm used the ‘normal approach’ (which requires immediate segregation of client monies). It seemed unlikely that FSA policymakers had intended that a lower level of protection should apply in that situation, particularly given that clients would have no knowledge of which approach the firm had adopted.

The merits of the generous approach as applied by the Supreme Court majority are, or at least were felt to be, that:

- It gives the greatest practical effect to the requirements of MiFID, that Member States should have in place a regime which protects clients’ money. If there are potential gaps in the protection afforded by the CASS 7 rules, then the courts should apply a purposive construction to the rules, so that the greatest number of clients are afforded the protection intended for them by the European legislature. The courts should not, in this exercise, feel unduly constrained by traditional principles of English trust law.

- It makes for the most equitable outcome: affording equal treatment to clients who are all ‘victims’ of a common misfortune – in this case, the sudden failure of Lehman Brothers.

\textsuperscript{3} Article 13(8) of the Markets in Financial Instruments Directive (2004/39/EC) and implementing provisions under Directive 2006/73/EC.
THE GAP IN CASS 7 WHICH CANNOT BE IGNORED

We mentioned above that the CASS 7 rules contain no provisions to address the possibility of non-compliance by an investment firm with the rules on segregation of client money.

In particular, if the rules contain no mechanism for tracing client money erroneously held in a firm’s general (unsegregated) accounts, or for calculating the client money entitlements of those clients whose money cannot be traced.

As we pointed out in our August 2010 briefing paper on the Court of Appeal’s decision, traditional English common law tracing rules differ depending on whether the firm (as a trustee of its clients’ monies) is ‘innocent’, where the tracing rule is that money most recently received in an account is deemed to be the first to be taken out, or whether the firm is a ‘wrongdoer’, in which case the firm is presumed to have withdrawn its own money first, thus allowing any remaining money in an account to be treated as client money.

The application of one rule rather than the other could lead to significantly different outcomes. Indeed, it is even arguable that both rules could be applied to different elements of the claims in the Lehman case.

Now that its practical significance has been exposed, if confidence and certainty is to be restored in the UK’s client money regime, this gap in the CASS 7 rules will need to be closed one way or another, and connected questions should also be addressed such as whether (and how far) putative client money claims may be traced into assets acquired with such money.

NEXT STEPS

This judgment is unfortunately just the end of the beginning. Creditors pursuing client money claims against the Lehman estate remain in the hands of the administrators, who must settle on a scheme for returning client monies to the (now enlarged) constituency of entitled creditors. Creditors will feel this distribution cannot come soon enough: the CASS rules seek “to facilitate the timely return of client money... in the event of the failure of a firm”, but almost three and a half years on, the process seems anything but timely.

Important legal and practical matters must now be addressed. In particular:

• The administrators must determine, with assistance from the High Court if necessary, which principles and techniques should be applied to give effect to the Supreme Court’s judgment, especially in relation to tracing client money into Lehman’s own unsegregated accounts.

• Clients’ entitlement to client money protection, which Lehman expressly agreed to provide under some contracts, will have to be established. This will of course potentially open the door to more litigation as clients look to establish and enforce their entitlements.

WHERE NOW FOR THE UK CLIENT MONEY REGIME?

Is it fair to say that the UK’s regime for protecting client money, in the sense of providing certainty of protection and timely return of client money on a firm’s default, now lies in ruins?
Quite possibly, if only for the following reasons:

• A client of an investment firm which has insisted on the separate segregation of its money in a properly constituted client bank account, and which is satisfied that this has in fact been done, still has no certainty that the investment firm has complied with its obligations to segregate the funds of all other clients. Following this judgment, those aggrieved (and potentially litigious) other clients may now make claims on the monies held in that segregated client bank account in the event of the firm’s failure; and their claims could well be so large as to dilute to an irrelevance the first client’s genuinely believed entitlement.

• There is at present no regulatory mechanism, and arguably no statutory framework which allows for such a mechanism to be created, to identify and arbitrate between those competing client claims.

Accordingly, the slightest irregularity or lack of timeliness in dealing with any client money on the part of a failed investment firm means that the process of distribution of all client money is likely to be both uncertain as to amount and painfully slow.

We now expect the FSA to complete its earlier review and overhaul of the CASS rules, which had been partially put on hold pending the resolution of this piece of litigation. It may also be necessary for the investment bank special administration regime to be modified to give supporting effect to the FSA’s overhaul. This could prove to be a tricky exercise, albeit that the FSA has supported the generous approach throughout the litigation. Key matters to be determined include:

• Whether to retain or abolish the alternative approach. Abolition could create serious practical difficulties for complex investment firms (difficulties the alternative approach was originally designed to mitigate).
  – One way forward might be that suggested by Briggs J. in the High Court: firms must keep a balance in any account(s) used under the alternative approach at least equal to the amount of client money to be segregated. The rules could then stipulate that this balance be treated as client money for the purposes of pooling.
  – Transparency as to the method adopted might also be regarded as a safeguard, perhaps in the expectation that market pressures would lead to many firms finding ways to mitigate or abandon the alternative approach.

• Tracing rules, especially where client money has, wrongly, not been identified as such, and instead used for the firm’s own purposes.

• Potentially some provision for a basis on which administrators can or should make an interim distribution to client money claimants, especially in a case as complex as the Lehman case.

In parallel, the Government will need to consider whether the statutory basis for the CASS rules needs to be amended to provide a concrete legal foundation for any set of expanded CASS rules. There is of course an opportunity to do so through additions to the Financial Services Bill now before Parliament. More radically, the Government could potentially even establish a new insolvency regime ‘client preference’ whereby all clients of an investment firm would rank ahead of general creditors for their client money claims. This would mirror the ‘depositor preference’ regime under consideration for bank insolvencies.
PRACTICAL RESPONSES

The Supreme Court judgment has in some respects created as many uncertainties for the UK client money regime as it has resolved. How then to respond? We suggest that, at a minimum, the following key steps should be taken (and indeed are being taken) by the clients of UK investment firms:

• Continue to look closely at arrangements with brokers and custodians for holding money, and indeed assets (notwithstanding that this particular case was not concerned with the custody rules relating to client assets).

• Where feasible, consider opting for more tailored segregation arrangements, although recognising that these arrangements may, if available, come at a price (notwithstanding that, as noted above, as far as client money is concerned, this may provide more limited protection than supposed).

• Focus on record-keeping and reporting obligations, and seek transparency and comfort on the controls used by investment firms to manage and monitor client money and asset balances (and ask the question of whether the firm uses the normal or the alternative approach to client money segregation).

• More fundamentally, consider keeping money outside the scope of CASS. Larger commercial banks may be regarded as a better credit risk than some investment firms (if only because of the ‘too big to fail’ implicit government guarantee) and a directly-held account at such a bank, over which a broker is given a mandate (for example) would not be subject to the uncertainties of the client money pool on the broker’s insolvency. However, it is important to recognise that the client concerned would then only be an unsecured creditor of the bank, with all the consequences that might have for the amount (if any) the customer would recover if the bank were to fail. An alternative might be to consider whether the broker would declare an express trust, in favour of its client, over the rights that it has against third party commercial banks where it places the relevant cash. All of these ideas run up against significant hurdles when considered on a cross-border basis, not least differing insolvency laws and varying degrees of acceptance of the concept of a trust.

• Consider whether a special purpose bankruptcy-remote structure could be made available to hold client money. Whether or not these structures avoid the CASS statutory trust depends very much on the facts, and specifically whether the firm is to be considered, on a broad view, to be ‘receiving’ and ‘holding’ the money placed with such structures.

If you would like to discuss the issues raised in this briefing paper, or any other financial regulatory matter, please contact one of the following or your usual Slaughter and May contact:

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