Reforming the UK Client Money Regime
A regulatory response to the Lehman litigation

In our Briefing of March 2012, commenting on the Supreme Court judgment in the Lehman Brothers case, we asked: “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?”

Our answer at that time was “quite possibly”. The FSA has now responded to that judgment by setting out a proposal for modifying the UK client money regime. In certain key respects the FSA’s proposal would push back on the Supreme Court’s reasoning in that case.

1. THE SUPREME COURT’S DECISION

In summary, the Supreme Court held in the Lehman Brothers case that:

- on the failure of an investment firm the client money ‘pool’ established under the FSA’s client money and asset regime (the CASS regime) includes not only the money actually segregated as client money but also any money held in the firm’s unsegregated house accounts which should have been segregated, or would have been segregated but for the intervention of the firm’s insolvency; this finding inevitably raised the prospect of further litigation, in particular concerning the “tracing” (according to complicated rules) of putative client money incorrectly ‘held’ in the house accounts; and

- the clients who are entitled to claim against the client money pool thus enlarged include not only those clients whose money was in fact segregated or identified in the house accounts but also any client who claims wrongly to have been denied client money protection notwithstanding their entitlement to such protection; thus the practical effect of the Supreme Court’s decision was to dilute the claims of clients whose money was in fact segregated with the claims of those whose money was not, and in the context of the Lehman Brothers case this dilution was potentially on a large scale.

The judgment has probably not unfortunately materially shortened the remainder of the already lengthy process of resolving the Lehman Brothers estate. The delay and uncertainty in that process has had and will continue to have ripple effects that are detrimental to confidence and operational efficiency in the wider financial system and in that sense regulated firms and their clients alike can be adversely affected.

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2. In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2012] UKSC 6.
As we noted in our earlier briefing, this state of affairs has demanded a regulatory response, and possibly also a legislative response if necessary. Essentially there are two policy choices, which can be mixed and matched to some extent:

- Change the law or rules to accommodate the Supreme Court’s decision in *Lehman Brothers* (for example, by providing tracing rules to establish entitlements and to provide for interim pay-outs where there are uncertainties and disputes).
- Change the rules to reverse the decision (for example, by making clear that the clients who share in the pool are only those whose money is correctly recorded in the firm’s books as being held in segregated accounts).

2. THE FSA’S CONSULTATION PAPER

The FSA published a consultation paper in September 2012\(^3\) setting out proposals for modifying the UK client money regime. One immediate purpose of the proposals is to make changes to the CASS rules that are necessary to implement recent EU requirements concerning the treatment of margin payments under the European Market Infrastructure Regulation\(^4\) (*EMIR*), which we summarise briefly at the end of this briefing. The other purposes are:

- to consult on proposed new rules to introduce “sub-pools” of client money, ring-fenced from one another, and dedicated to particular classes of client and/or particular classes of business; and
- to open a formal discussion of other ways of improving the CASS regime to remove or mitigate the deficiencies identified in the *Lehman Brothers* case and, indeed, the difficulties which flow from the Supreme Court judgment itself.

2.1 Client money sub-pools

The FSA describes the introduction of sub-pools of client money as (if implemented) the “most radical change … to the client money regime in over 20 years”.

The thinking is as follows: instead of all client money (including money categorised as such by the Supreme Court in *Lehman Brothers*) forming one single ‘pool’ on the firm’s insolvency, some or all client money could be allocated to two or more sub-pools, each with its own distinctive parameters set by type of client and/or type of business. The FSA canvasses the idea that there could, for example, be:

- two main sub-pools (which could be made mandatory), holding retail and non-retail client money respectively;
- further optional sub-divisions of these pools (for example, according to particular business lines); and/or
- special sub-pools for particular types of client (for example, prime brokerage clients) or types of business, with the remainder of client money in a general client money pool, as at present.

The fundamental principle would be that, in the event of the relevant investment firm’s insolvency, a client with a client money claim would only have recourse to the relevant sub-pool and not to any other. On its own this

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\(^3\) *Client assets regime: EMIR, multiple pools and the wider review (CP12/22)*, September 2012.
proposal, as the FSA itself admits, would not alter the impact of the *Lehman Brothers* judgment, in that it would still be necessary to identify client money held in the firm’s house accounts and to allocate it to one or more pools; and creditors could still claim to be entitled to a share of client money on the grounds that their money should have been segregated but was not.

At the same time, however, multiplying the number of pools of client money might be expected to increase the likelihood that:

- shortfalls will not occur in *all* pools; and
- creditors could not claim to be entitled to share in *all* pools.

The result in practice should, therefore, be that clients whose money is held in ‘non-disputed’ sub-pools could expect their money to be distributed in full and more rapidly.

However, whilst the likelihood of a less complicated distribution for some clients should in theory be increased by the sub-pool proposal, the FSA acknowledges that the proposal equally presents some new risks. In particular:

- there may nevertheless be disputes over where client money shortfalls, and therefore losses, are allocated, or disputes concerning which pool a client correctly belongs to; and
- there is an increased risk of operational error, because of the complexity of managing multiple pools and sub-pools of client money (for example, money may be allocated to the wrong sub-pool, or a client may be given incorrect information concerning allocations or entitlements).

**Comment**

In principle, the proposal for multiple sub-pools, whether on a mandatory or optional basis, would seem to hold attraction for those on the ‘client’ side of this debate. Indeed, the proposals envisage that a client may be able to agree with an investment firm that its money will be held in a sub-pool dedicated to its monies alone, separate from all other client money. Such a client could be fairly confident (operational errors aside) that its money is then properly protected and should be recoverable reasonably promptly in an insolvency scenario.

It is not difficult to see why those on the ‘firm’ side of this debate will feel that the costs and complexity of maintaining (perhaps numerous) sub-pools would pose a major administrative and compliance challenge, and add significant pressure to the role of the client asset oversight officer (and the auditors supporting him or her). All of this will inevitably increase the costs of maintaining client money accounts, and it seems likely that clients will be asked to carry some or all of those costs.

Multiple sub-pools as a concept was considered and ultimately dismissed by the FSA when the terms of what is now the CASS regime were being finalised. At that stage, the increased costs angle was recognised, but the single client money pool seemed in fact to be preferred largely on grounds of equality of treatment and simplicity of administration; it was also preferred on the grounds that “it reduces the time and cost involved in distributing entitlements to clients following a default [because] it eliminates a layer of work for the Insolvency
Practitioner to establish that the right balance is in the correct type of account”. Interestingly, one argument that was made against multiple sub-pools at that time was that it “would be likely to increase the time and cost of making [a distribution] and may increase the degree of reliance on directions from the courts”.

With the benefit of hindsight we might say that contrary to those expectations the empirical evidence suggests quite the opposite: the single pool approach may have reduced rather than increased the speed and certainty of distributions. But there is doubtless substance in the concern implicit in the FSA’s preference in 2000 for a straightforward single pool approach, namely that the administrative complexities of operating multiple client money accounts and ledgers poses a potentially material operational risk. Recent experience suggests that in the days and weeks preceding a failure, administrative and operational strains will be exacerbated by, among other things, extraordinary efforts being deployed internally to the firm to find a means to avoid failure; a substantial increase in movements of client money and assets into and, more commonly, out of the firm; and significant strains on the individuals involved.

So while multiple sub-pools have attractions on paper, the efficacy of their operation in practice may well be another matter. Firms are already able to operate multiple segregated client money accounts, including accounts which are ring-fenced for specific clients or groups of clients, but until recently this had tended not to be a model commonly offered or sought. Investment firms and their clients alike will now need to contemplate the question implicit in the FSA’s proposal: at what price certainty (or, at least, greater certainty)?

2.2 Other improvements to the CASS regime

Under the heading “Client assets regime: achieving better results”, CP12/22 sets out for discussion various other ideas for improving the efficiency and effectiveness of the CASS regime. In particular, the FSA would like to:

- improve the speed of return of assets following an insolvency;
- achieve a “greater return” of such assets; and
- reduce the “market impact” of the insolvency of an investment firm holding client assets (i.e. addressing the practical concern exemplified by the Lehman Brothers case that the current CASS regime can leave money and assets trapped for a prolonged period).

The FSA acknowledges that the current regime “effectively prioritises accuracy over speed”, but comments that it is not just the CASS rules which determine this priority. CASS sits within a statutory framework with three pillars: the Financial Services and Markets Act 2000 (FSMA), UK insolvency law and UK company law. Moreover, the FSA points out, there is a necessary interaction between any proposals which the FSA may devise and the UK Government’s plans for a “resolution regime” for systemically important investment firms, which would grant the authorities overriding powers to control the fortunes of failing investment firms in similar ways to those now in place under the UK’s special resolution regime for banks.

The FSA concedes that the special administration regime for investment firms (introduced in February 2011 in response to the Lehman insolvency) has had limited success in speeding up the return of client assets. One
reason for this which is alluded to by the FSA is that, under UK insolvency law, individual insolvency practitioners appointed as administrators or liquidators can incur personal liability for their conduct and this fact can heavily influence those individuals to seek absolute legal certainty in preference to making rapid payouts. Commentators have contrasted this with the position in relation to US investment firm bankruptcies where insolvency practitioners have been able (and perhaps more willing) to contemplate comparatively rapid interim payouts to client money and asset claimants.

2.3 Increasing the rate of return of client money
Against the background of the accepted wisdom that an effective system of corporate insolvency requires legal certainty, and that legal certainty is usually the enemy of speed, the FSA has tentatively proposed what it regards as only “marginal” improvements to its existing CASS rules.

In essence, the proposal canvassed by the FSA is to reverse the effect of the Lehman Brothers judgment by amending the CASS rules to provide that client entitlements to share in the general client money pool should be “based on the firm’s specific records of segregated client money or assets”. In other words, if you thought that funds held by your broker were segregated and protected but in fact they were not, and there is no record to the contrary in the firm, you will not have a proprietary client money claim and will have to join the queue of general creditors.

Comment
This alternative approach was of course essentially what was argued for by the unsuccessful parties in the Lehman Brothers litigation. The consultation paper does not go as far as spelling out the legal effect of taking this narrower approach, but seems instead to be seeking at this stage only to test the strength of opinions on the idea.

It is difficult for ‘client-side’ organisations to know which way to respond on this point because history shows that the difference between being on the right and the wrong side of the courtroom in a practical insolvency situation can come down to an administrative error on the part of the investment firm.

The policy question may boil down to one of whether the UK client money regime should protect the many who may, objectively, be entitled to expect protection, or the few, or fewer, who take steps to verify and ensure (as far as possible) that they are in fact receiving the protections they expect.

A legal concern with any proposal to reverse the Supreme Court’s decision is that one of the reasons why the majority in the Supreme Court granted entitlements to a broader class of claimants was that the wide interpretation of the concepts of “client money” and “client money entitlement” which underlie that decision were felt by the Supreme Court to give best effect to the EU legal requirement (specified in the Markets in Financial Instruments Directive, MiFID) that client money and assets should be adequately protected. By narrowing these two key concepts, there would be a question as to whether the FSA’s proposal would impermissibly derogate from the maximum harmonisation requirement of MiFID.

The FSA’s proposal, if implemented, would probably be supported by an enhanced requirement for investment firms to provide their clients with regular statements concerning money and assets held for them (similar to requirements already applicable to prime brokers under the CASS 9 rules). Barring errors on these statements, this regular disclosure should enable clients to monitor more effectively whether their expectations of client money and client asset protections reflect the reality of the service being provided, and thereby should provide the rationale for limiting protections to those whose monies have in fact been segregated.
The FSA has also noted that the use of client money mandates (where a firm is given the authority to operate a
bank account maintained by a client in the client’s own name) can provide more reliable protection on a firm’s
insolvency because the client’s money is never in the possession of the firm. The consultation paper states that
the FSA is considering providing “incentives” (as yet unspecified) to encourage greater use of such mandates in
appropriate cases. At present, this remains one of the more straightforward and effective means by which client-
side organisations could address the concerns associated with broker/manager insolvency risk in relation to client
money.

An alternative and more radical approach that will also now be considered (at something of a tangent to the
principal proposition outlined above) is, in effect, to extend the Supreme Court’s benevolent reasoning beyond
the realm of the client money regime. Under this approach, the FSA has suggested that the new CASS regime
could potentially provide for the pooling and liquidation of all custody assets and client money held by a failed
investment firm, with all clients then sharing proportionately in the cash pool thus created (and of course therefore
also sharing in any shortfall). The FSA cites the US as an example of a jurisdiction where this approach may already
be applied, noting that it could facilitate a more rapid and cost-efficient distribution, albeit not without potentially
significant drawbacks for certain clients (in particular clients with strong custody asset claims).

2.4 Achieving a greater return
Under this heading sit the FSA’s proposals to maximise the amounts which are eventually returned to clients:

• Investment firms could be required to maintain a “buffer” of money in segregated client bank accounts
to absorb potential insolvency costs or other losses and thus transfer the risk of losses from clients to the
firm itself in much the same way that regulatory capital transfers the risk of losses from general creditors to
investors.

• Investment firms could be required to take out insurance against client money and asset losses. This would of
course imply higher costs for investment firms, and therefore their clients.

• The FSA highlights the weakness of the “alternative approach” to client money segregation (explained in our
earlier briefing paper7), whereby client money can be mixed with the firm’s own money on a daily basis with net
balances only being segregated the next day. The alternative approach leaves clients exposed to the risk of their
money becoming trapped in the house accounts (i.e. before segregation takes place) at the onset of insolvency;
this was one risk that had crystallised in the Lehman Brothers case. The principal means of addressing this
weakness would be either to abolish the alternative approach altogether, or to adopt a different approach
(first described by the High Court in the first instance hearing of the Lehman Brothers case) under which the
firm would be required to ensure that there is always a balance maintained in the firm’s client accounts which
equates, based on experience and reasonable assumptions, to the likely client balances for that day.

• More controversially, the FSA could create an insolvency preference hierarchy among clients, so that certain
classes of client (e.g. retail clients) are paid out in priority to others. The FSA already applies a statutory trust to
client money interests because it was empowered to do so by FSMA. In our view, additional primary legislation
would be required if the FSA or its successors wanted to create a trust for client assets, or an equivalent
mechanism for preferring certain clients, because such an arrangement would need to override existing UK
insolvency law. This is also another proposal which risks offending against MiFID, which demands protection for
all clients and without implication that a hierarchy of protected clients may be created.

7 See footnote 1
2.5 Reducing the market impact of insolvency
As noted above, the introduction of a resolution regime for systemically important firms is intended to facilitate the management of the failure of such a firm in ways that avoid or minimise adverse market impact.

Nevertheless, the FSA has recognised that there is still a risk of material harm to the financial system (falling short of systemic danger) arising from the failures of other types of firm. This is mainly because the onset of insolvency ‘freezes’ all activities and positions, with a view to liquidation and the distribution of assets to creditors (subject to the attendant delays noted in our earlier commentary). This is inevitably contrary to the interests of many clients whose funds and assets are caught up in that process; those clients may often prefer to see the business continuing to operate, if possible, either by means of the firm being placed into a managed run-off process, or through the transfer of its business and positions to another more stable firm in order to maximise the efficiency of the distribution process.

Accordingly, the FSA has suggested two related ideas:

- giving insolvency practitioners the option of not triggering a client money pooling event on the firm’s failure, so as to be able to sell all or part of the business of the firm as a continuing concern; and

- allowing firms to obtain the “pre-consent” of clients to transfer assets, to facilitate such a post-insolvency sale.

These ideas may to some extent be overtaken by the EU recovery and resolution regime, if implemented and, as noted above, the scope of the EU proposals as currently contemplated would not be confined to systemically important investment firms.

3. EMIR ReFORMS

EMIR, which came into force on 16 August 2012, requires central counterparties (CCPs) to have the ability to “port” client money held as margin in the account of a failed investment firm clearing member to another clearing member or members, alongside the portable client positions of that failed member.

To give effect to this requirement, the FSA has proposed to require that client transaction accounts maintained by investment firms with CCPs are organised as separate distinguishable accounts so as to permit porting, where this is possible, or to permit the CCP to return client money directly to known clients of a failed clearing member, where that is possible.

If neither is possible, the thinking is that segregated client money could be returned to the firm, either to form part of the general pool of client money that will arise following its failure or, where a client has arranged for individual segregation arrangements, the money will be returned directly to that client and will not go into the general pool.

In effect, therefore, EMIR has necessitated a prototype of the sub-pool concept proposed by the FSA to be applied more generally, as discussed above. The fact that directly applicable EU legislation will require the creation of sub-pools may suggest that sub-pools are more likely than not to become a feature of the CASS regime following this consultation process.
4. OUR ASSESSMENT OF THE FSA’S REGULATORY RESPONSE

The starting position of the FSA’s proposals appear to be that:

- the existing CASS rules on client money have been found (by the Supreme Court) to be critically ambiguous, and fail to set out a clear path to dealing with the multiple problems highlighted by the Lehman Brothers insolvency; and

- the Supreme Court’s solution to the task of making some workable sense of the rules arguably creates a new set of uncertainties, and certainly does relatively little to reduce the prospect of litigation causing lengthy delays to any distribution of monies or assets to the clients of a failed investment firm.

The FSA’s decision to advance the dialogue on reforms in this area is doubtless to be welcomed, although as yet it has not been possible to put forward a comprehensive and coherent blueprint for reform, with the FSA admitting that this endeavour will ultimately require a co-ordinated review of relevant primary legislation. Any such review will be constrained by the requirements of MiFID and its successor EU legislation, as we have noted in the discussion above.

At this stage our initial observations are that:

- Some combination of (i) the sub-pool proposal, (ii) the deeming of client money entitlement to be based on actual recorded segregation and (iii) enhanced client reporting requirements, could inject much needed certainty into the core aspects of the CASS regime. Taken together, these measures do not seem incompatible with MiFID.

- Equally, we must recognise that while these reforms may be positive, they cannot ‘solve’ all of the difficulties experienced by clients in the Lehman Brothers situation – human and system failures to segregate money and assets cannot be legislated away, and experience suggests that in the days and weeks preceding an investment firm’s failure these risks could increase materially, and probably in proportion to the complexity of the segregation arrangements.

- The additional flexibility that may enable authorities to allow a failed investment firm to run off on a going concern basis and/or to arrange a (prompt) transfer of its business, to the benefit of clients seeking return of money and assets, seems in principle to be a proposition that should be welcomed.

- Inevitably, investment firms would be faced with materially greater operational and administrative complexities as a consequence of these reforms, and therefore a greater management challenge. Clients will inevitably bear at least some of the costs implied by the additional complexities and challenges.

- Some clients have already sought ‘self-help’ methods of protecting against investment firm failure, including the more common use of bank account mandates and express trust arrangements in relation to assets. A key question may be, therefore, whether the incremental legal certainty benefit of mandating sub-pools and enhanced reporting are felt by all or a majority of those affected to justify the associated cost and burden (both for firms and their clients).
5. CONCLUDING THOUGHTS

The inability of the UK’s client money and assets regime to respond adequately to the failure of a major investment firm exposed structural design faults that had largely been concealed from view up to that point.

Now that those faults have been revealed, the FSA is taking its first serious steps with this consultation paper to draw the blueprint for a more resilient and pragmatic regime. There are aspects of the proposals, notably the idea of sub-pools, which on paper at least give client-side organisations in particular cause for some optimism.

There are nevertheless complex legal issues involved which lead us to believe that it may only be once the substructure of UK insolvency and corporate law can be properly revisited that the superstructure can be expected to bend sufficiently to avoid once again being left in ruins by the next big investment firm failure.