NEWSSTAND

# *Lehman* Case Blows a Hole in FSA's Client Money Rules

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Protecting clients' money and assets has been a pillar of the UK financial regulatory regime. The obligation on regulated entities to "*…arrange adequate protection for clients' assets when it is responsible for them*" is enshrined in Principle 10 of the Principles of Business Sourcebook of the Financial Services Authority (FSA) Handbook. The FSA has made rules to protect client money by requiring FSA regulated entities to hold such money in trust accounts (the Client Money Rules). Client money held in a trust account is protected in the event of the insolvency of the regulated firm because it is ring fenced and does not form part of the insolvent estate available to pay the general pool of creditors.

The Client Money Rules are contained in the FSA's Client Assets Sourcebook (CASS). CASS chapter 5 contains the client money rules that apply to firms carrying out insurance mediation activities and, broadly, CASS chapter 7 contains the rules applicable to firms carrying out investment services and activities.

The recent case of *Lehman Brothers International (Europe) v CRC Credit* [2009] EXHC 3228 (Ch) has highlighted that the Client Money Rules are patently flawed and ultimately only provide protection for client money to the extent that firms comply with the rules. Whilst the case considers CASS 7 and is therefore directly relevant to investment firms and their clients, a number of the issues equally apply to CASS 5 and therefore insurance intermediaries and their clients.

**The *Lehman* Case**
Mr Justice Briggs' judgment in the Lehman case considered issues relating to the identification and distribution of the client money held by Lehman Brothers International (Europe) (LBIE) when it was placed into administration. At that time LBIE had credit balances totalling US$2.16 billion in accounts exclusively for segregating client money. When segregating client money LBIE used the so-called "alternative approach" allowed by CASS 7. This involved LBIE receiving and paying client money into and out of its house accounts on the basis it was obliged to perform daily reconciliations of client money and to transfer money to top up or reduce the sums held in its segregated client accounts.

However, LBIE was extremely lax when reconciling client money for its affiliates. Mr Justice Briggs has described its failure as "truly spectacular" and involving "shocking underperformance". The judgment limits the recovery of claims in the LBIE insolvency by clients who may have assumed that their assets were protected. We consider below a number of the key issues and the extent to which they undermine the protection afforded by the Client Money Rules.

***Failure to Segregate***

First, the judge considered the time when the trust in respect of client money arose and what use LBIE could make of such money pending segregation. Did it arise when LBIE received client money or when it segregated it? If the latter, was LBIE free to use the money as it wished pending segregation? It was held that where client money was received from, or for the account of, a client, the trust arose when the monies were received by LBIE. If it had arisen only on segregation there would have been a gap between receipt and the time when the monies were segregated. Where client money is received by a firm, it does not cease to be client money on receipt and only become client money again on segregation.

***Pooling of Client Money***

CASS rule 7.9.6 states that client money held in each client money account of the firm is treated as being pooled on the failure of a firm. One effect of this rule is that even where a segregated client account is used specifically for one client and the whole of the money in that account belongs to that client, on the failure of the firm the money in that account is pooled with all other client money, so that if there is an overall shortfall of client money in the pool, the rights of the client who was entitled to the segregated account will reduce along with all other clients.

In the *Lehman* case, the court considered whether the client money pool included all identifiable client money or only client money which had in fact been segregated in accordance with the Client Money Rules. It held that when the primary pooling event (referred to in the judgment as a PPE) occurred, ie the insolvency of LBIE, the client money pool consisted only of client money actually held in segregated accounts.

The judge held that there was no requirement to top up the client money pool after a PPE to make good a shortfall arising as a consequence of events happening after the date of insolvency (for example, because open positions have improved since the time of last segregation), since this would cause inroads into the principle of pari passu distribution of the company's assets to unsecured creditors on an insolvency. Thus any shortfall caused by money being held outside the client money pool represented an unsecured claim against the firm except where the money was identifiable and could be traced.

Shortfalls in client money can occur in a number of different ways and, in the earlier case *Re Global Trader Europe Ltd* (No 1) [2009] EWHC 602 (Ch), a shortfall occurred for a totally different reason, namely the firm's bankers failing to effect the firm's instruction to make a balancing payment to correct a payment that was mistakenly made out of its segregated account.

**Calculating Clients' Shares**

The court in the *Lehman* case also considered the basis upon which clients' shares in the client money pool were to be calculated. It was held that clients' rights were to be assessed by reference to the amount of client money which had in fact been segregated (the "contribution basis"), not by reference to the amount which should have been segregated (the "entitlement basis").

Mr Justice Briggs then considered the correct date for calculating clients' shares in the client money pool. The two golden rules which apply where parties share in an insolvent fund are (i) that the same date must be used for calculating all parties' entitlements, and (ii) that the calculation should be made as soon as possible. In a company insolvency, the date for calculating claims against the fund of assets is the date of the winding-up order. The judgement followed the decision in the Global Trader case that in administration this was the date of the administration order.

Gains accruing because of movements in currencies or the closing of open positions after the date of administration, are pooled into the common fund and all clients benefit or lose rateably according to whether the size of the fund goes up or down.

***Set off***

Finally, did LBIE have any right to set off its claims against clients' entitlements to client money? The judge found that a client's proprietary right to receive a share of the money in the client money pool was a right as beneficiary against LBIE as trustee of the trust. The client money pool was a trust fund of which the clients were the beneficial owners. Insolvency set-off was only available where there was a debtor-creditor relationship in both directions, not where one of the parties had a proprietary claim for the delivery of its property. Accordingly, LBIE could not set-off its claims against clients against their client money entitlements.

The amounts at stake in the Lehman case are substantial and an appeal was filed on 15 January 2010.

**HM Treasury Consultation Paper**

On 16 December 2009 HM Treasury issued a consultation paper entitled "*Establishing resolution arrangements for investment banks*" (the Treasury Paper) on various proposals to improve the regime around the failure of investment firms and to protect and enhance the UK's reputation for investment banking business. The proposals include suggestions with regard to the operation of client money accounts and the protection of client assets, which are likely to result in changes to the Client Money Rules.

The Government is also considering creating a client assets agency for pre-insolvency supervision of client money.

**FSA Client Money and Asset Report**

Following visits over the previous six months to a range of investment and insurance broker firms, the FSA published a report (the FSA Report) on 19 January 2010, identifying a number of failings in firms' compliance with the Client Money Rules. The FSA believes that the failings identified at these firms is indicative of weaknesses across the market. Weak areas discovered included: poor management oversight and control; lack of establishment of trust status for segregated accounts; and incomplete or inaccurate records, accounts and reconciliations (especially relevant considering the *Lehman* case). As a result, the FSA intends to put in place arrangements to raise the level of awareness across the market of compliance with the Client Money Rules.

The FSA intends to work on the following in 2010:

- Increased firm visits, exercising regulatory intervention where it finds CASS failings and producing a further report of the findings later in 2010.
- Improving the standards of CASS audits. The FSA is now working with the professional standards section of the Institute of Chartered Accountants in England and Wales (ICAEW) to create referral arrangements for the ICAEW to investigate cases where the FSA has concerns surrounding the CASS audit report.
- Reintroducing client money reporting.
- Working closely with HM Treasury to publish an FSA consultation paper on amendments to the CASS rules in the first quarter of 2010 addressing the failings raised by the *Lehman* case.

The FSA has concluded that there is still a significant amount of work for firms to do in order to ensure clients' money and assets are adequately protected. Following the FSA's visits in 2009, it took a large number of regulatory actions.

**Recommendations**

The *Lehman* case highlights the risks associated with depositing client money with an investment firm or insurance intermediary, where the firm does not comply with the Client Money Rules. However, it should be noted that the "alternative approach" (described above) allowed for investment firms under CASS 7 is not available to insurance intermediaries under CASS 5, therefore, the risk of client money not being segregated and consequently a shortfall arising should be lower.

Pending the outcome of any appeal and probable changes to the CASS rules resulting from the Treasury Paper and the FSA Report, clients can improve their protection by carrying out the following:

- Clients may specify where client money is to be deposited, for example by requesting that money be placed in a "designated client bank account" with a specific bank that they have satisfied themselves is not at risk of insolvency. If another bank which holds client accounts for a firm fails, then the account will not be pooled. However, if the firm fails, the designated account will be pooled with other client accounts and, therefore, subject to any shortfall.
- Clients of investment firms should specify that the firm can only use the normal approach rather than the alternative approach, so that all client money will go straight into a segregated client account rather than through the firm's house account.
- Clients should carry out thorough due diligence in relation to the client money deposited, to ensure that it is being held in a segregated account.