



# Client assets: enhancement or a missed opportunity?

The UK's Financial Services Authority has published a consultation paper on proposed changes to its client assets rules. These address some of the problems highlighted by the failure of Lehman, though not all of them. This briefing outlines the client protection issues arising from the Lehman administration and how the consultation paper addresses them. Firms carrying out prime brokerage work in particular should watch these developments closely and be aware that clients are more closely scrutinising their performance in this area.

## Introduction

In the aftermath of the failure of Lehman Brothers and HM Treasury's consultation document on *Establishing resolution arrangements for investment banks* of December 2009, the Financial Services Authority (FSA) has published consultation paper (CP) 10/9 entitled *Enhancing the Client Assets Sourcebook*, with a view to changing the client assets rules (the CASS section of the FSA Handbook) to strengthen client money and client asset protection. Although the proposals contain some sensible measures to further protect client assets, some proposals have been criticised as unnecessary. Furthermore, they do not address certain issues with CASS that were highlighted in the judgment of Mr Justice Briggs in *Lehman Brothers International (Europe) v CRC Credit Fund and others* [2009] EWHC 3228 (Ch) in what he characterised as 'the imperfect and hugely complex real world occupied by LBIE and its numerous clients'. The FSA does, however, promise further proposals in this area and may be awaiting the appeal of this judgment (scheduled for 16 or 17 July) before setting out definitive proposals in certain areas.

## What the Lehman judgment found

Mr Justice Briggs held as follows:

- the statutory trust over client money arises from the moment client money is received by a firm and not from when it is segregated;
- under the alternative approach, the firm must ensure that client money that is mixed in a house account

pending segregation is not put at risk or used for the firm's own purposes. Mr Justice Briggs suggested that this could be achieved by one of two methods. First, the firm can maintain a minimum balance on the house account to cover the client money, based on historical data, and ensure that there is no charge or liquidity management arrangement that would erode the minimum balance; or, second, it can include a 'prudential buffer' in the client money account, again calculated using historical data;

- the client money pool to which CASS applies (ie money easily identifiable as subject to the statutory trust) (CMP) consists only of money in the firm's segregated client accounts;
- the only remedy available in respect of client money that has not yet been segregated or that the firm has wrongly failed to segregate is generally the equitable remedy of tracing;
- a client's share of the CMP is determined by the actual amount the firm segregated for that client, not the amount that should have been segregated – ie there is no mechanism in CASS for correcting non-compliance with the CASS rules or for topping up the CMP with client money held outside the CMP or from the firm's general estate;
- a client's share of the CMP is calculated at the date the CMP was constituted – ie on administration of LBIE. Events that occur after that date (such as exchange rate fluctuations or the movement in open positions) are generally not taken into account when calculating a client's entitlement; and

- there is no set-off between a client's entitlement to a share of the CMP and claims of the firm against the client.

## Issues highlighted by the Lehman judgment

As several counterparties found to their cost, the objectives of the CASS rules were not met. Mr Justice Briggs summed these up as 'first, that the client's money could not be used by the firm for its own account and secondly, that upon the firm's insolvency, the clients would receive back their money in full'. In fact the judge opined that 'there has... been a falling short in the achievement of both of those objectives on a truly spectacular scale'. The two prime causes highlighted for this failure were:

- LBIE failed to identify and segregate vast sums received from or on behalf of a significant number of its clients (these also included claims by its own affiliates totalling \$3bn); and
- the associated insolvency of Lehman Brothers Bankhaus AG, a German bank with which LBIE had deposited \$1bn, nearly half of its segregated client money.

One of the main reasons for the non-segregation of client monies was the fact that LBIE operated the so-called 'alternative approach' permitted by CASS under which client monies may be paid initially into the firm's own bank accounts rather than immediately being paid into the firm's client money bank account. An internal reconciliation is then conducted every business day so as to top up or reduce the amount held in segregated client accounts. This ensures that the aggregate amount segregated is equivalent to that required to be segregated under CASS. However, this system only works on a going concern basis. As was seen with LBIE, the last reconciliation before administration did not reflect the subsequent receipts and payments of client money into and out of the house bank accounts on the business day before administration and the CASS rules were silent on the treatment of such client monies.

Therefore, clients who had paid in client money after the time of last reconciliation did not have this money segregated so as to form part of the CMP. Similarly, where a mistake had led to client money not being segregated, clients found themselves with no remedy other than the equitable remedy of tracing, which was of no practical

use given the high level of complex transactions, the lack of information and the overall shortfall of money and assets.

## What the CP proposes

### Increased disclosure by prime brokers of rights of use

Even professional clients did not fully appreciate the consequences of LBIE failing, especially where client assets were subject to a contractual right to re-hypothecate. The FSA proposes that prime brokers include a disclosure annex in the prime brokerage agreement (PBA) that summarises the contractual re-hypothecation provision, sets out the risk to the client in the event of the prime broker's default and cross-references the relevant provisions in the PBA. In addition, relevant definitions such as net client indebtedness and any contractual limit on re-hypothecation would need to be highlighted.

The FSA believes this may help reduce the time for legal due diligence undertaken by an insolvency practitioner in the event of a prime broker's insolvency. However, although the annex may give a useful summary of the right of a prime broker to use the client assets concerned, it will provide little more than an index for an insolvency practitioner, because the contractual obligations will remain in the PBA and it is this source document that would need to be studied in detail on insolvency to ascertain the legal provisions governing the assets and not the summary. Given the need for prime brokers to amend all existing PBAs to ensure they contain such an annex, this appears to be an expensive measure that provides little benefit to clients, especially given that the vast majority of prime brokerage clients are professionals and fully understand the risks involved.

Concerns have also been raised over the proposed definition of a prime broker. The definition requires a firm to provide all of the following services to be a prime broker: custody or arranging the safeguarding of client assets; clearing services; and financing services, to include each of capital introduction, margin financing, stock lending, stock borrowing and entering into repo or reverse repo transactions. Although these are the services that prime brokers typically provide, it may be that other firms that provide a full range of services to clients, perhaps through a number of divisions, are caught by this definition when they are not in fact prime brokers.

### **Daily reporting to prime brokerage clients**

On LBIE's insolvency, clients generally did not have access to up-to-date information about their client money and asset accounts. Uncertainty existed over whether pre-insolvency instructions had been executed, which assets had been fully or properly segregated and which of the clients' assets had been re-hypothecated.

Since the collapse of LBIE, the prime brokerage market has reacted to the concerns raised during that period by introducing daily reporting for clients and this is now industry standard. The FSA welcomes this and proposes to standardise the daily reporting. Although daily reporting has entailed significant IT investment, it should help to inform prime brokerage clients about the recent location and use of their assets and limit the scope of damage were a major prime broker to collapse again.

However, all information in a real-time market, even if provided on a daily basis, is, by its very nature, historic the moment that it is produced and therefore clients cannot fully rely on it. LBIE had performed a daily reconciliation of client money and assets on the Friday, being the business day prior to its collapse before market opening on the Monday. This reconciliation was based on the position at close of business on Thursday. The problems largely arose due to the vast amounts of money and securities moved on the Friday.

### **Restriction of the amount of client money deposits held with group banks**

A firm will place client money on deposit, usually with a number of banks, some of which may be in the same group as the firm. If any of these banks fails, the firm is not liable to the client for any client money so lost, provided the bank has been chosen with due diligence. LBIE had placed large amounts of client money on deposit with its German affiliate bank, which also went into insolvency, thus increasing the shortfall of client money in the CMP.

The FSA proposes that a maximum of 20 per cent of total client money may be placed with an intra-group bank. To support this it points to the risk of contagion – that the firm and its affiliates will fail either simultaneously or within a short time of each other. Where a group is in difficulty, the risk is that inappropriately large amounts of client money may be used as a source of group liquidity by depositing them in a group bank.

The proposal works against those entities that do not hold a banking licence. Such a firm receives money as banker and does not hold the money as client money but as banker. It is therefore free to deposit the money with its affiliates as it wishes. A firm without a banking licence must hold the money as client money and would be subject to the proposed limit.

Since firms must currently have regard to diversifying client money holdings, this proposal may be acceptable to the industry. However, there may be jurisdictions in which the only reputable option is an affiliate of the entity in question and it may be preferable for any limit to be waivable at a client's request.

### **Prohibiting the use of general liens in custodian agreements**

Current FSA guidance requires firms to consider restrictions over a third party's right to claim a lien over any safe custody asset. Following LBIE's insolvency, liens have contributed to significant delays and obstacles to the recovery of client assets from custodians. The FSA proposes to turn this guidance into a rule to restrict the use of general liens in custody agreements and to permit a lien only if a firm does not pay custodian fees and charges to the custodian.

This may be difficult to comply with when doing business in certain countries where custodians require a more general lien or do not distinguish between a firm's assets and its clients' assets. In addition, liens are often required for the purpose of client financing to cover exposure of the firm to clients arising from providing custody services – eg contractual settlement exposures. Further, some custodians refuse to do business except on their own standard terms, which may contain a general lien.

### **Establishment of a CASS oversight function**

The proposal is to appoint one person at certain firms to have ultimate oversight responsibility for CASS. This is a sensible proposal that formalises best practice in the area, even though operationally the responsibility may fall within the role of several persons in the operations, finance and corporate treasury departments. This is formalising the approach the FSA set out in its 'Dear CEO letter' of January 2010, in which it clearly states that the board, the chair of the risk committee (where

appropriate) and those individuals who are responsible for risk and compliance with CASS are all 'accountable for the protection of the firm's client money and client assets'.

### **Re-introduction of a client money and assets return**

This proposal requires firms to report on their client asset position, in a similar manner to that previously required by the FSA's predecessor self-regulatory organisations, particularly the Securities and Futures Authority. Reporting is proposed monthly for large and medium firms and bi-annually for smaller firms. The FSA proposes to use the information gathered to monitor compliance with CASS and to monitor trends both within firms and in the wider market.

The collapse of Lehman has highlighted the need for accurate and timely record keeping for client money and assets and, provided the information required is that which firms and their clients already use and rely on, this should not create a large additional burden for firms. The FSA notes that the client money and assets return may help an insolvency practitioner by ensuring information from the previous reporting period is available immediately but, as noted above, in a real-time market, any historic information is out of date and would be inadequate for the purposes of calculating entitlements of clients in an insolvency.

### **What the CP doesn't address**

The Lehman judgment is subject to appeal and it may be that the FSA is waiting on the Court of Appeal's findings before proposing further amendments to CASS. However, this is not stated in the CP, which is surprising.

The CP does not address the issue of whether firms should be allowed to continue to use the alternative approach that strips away many of the client money protections unless and until the money is properly segregated by the firm (potentially creating what the judge described as 'a black hole'). Nor does the CP seek to address the inconsistencies and flaws in CASS highlighted in the judgment.

If the FSA proposes to continue to permit the alternative approach to be used, Mr Justice Briggs stated that the operation of such a system should be enhanced so that clients' money is not put at risk, for example by

the firm (i) maintaining a minimum balance on any house account used for the receipt of money under the alternative approach such that the balance of this account was never less than the amount of client money attributable to its clients or (ii) establishing a segregated client account into which an amount equivalent to the client money held in the house account could be credited, in either case using historic data. However, the efficacy of these suggestions is dependent on a firm calculating the amount to be kept as a buffer or segregated correctly. The FSA has said (in its 'Dear CEO' letter of January 2010) that it will be scrutinising the use of these options by firms.

In addition, the judge highlighted the fact that the rules were 'silent as to the consequences of mixing client money with the firm's own money in house accounts, in terms of the fiduciary obligations which may thereby be imposed on the firm'. In the absence of any legislation permitting a shortfall in the CMP to be topped up from the firm's own funds post insolvency, the judge found that to do so would infringe the principle of English insolvency law that a firm's property is to be distributed *pari passu* among unsecured creditors. However, the judge also found that client money that had not been segregated at the time of insolvency did not form part of the CMP but was subject to the equitable remedy of tracing. Since this treats clients that have entrusted client money to a firm differently depending on whether their money has yet been segregated by the firm, it is interesting that the FSA did not consider proposing amendments to CASS to bring into the CMP client money paid to the firm but not yet segregated and client money that has not been segregated due to the firm's error, at least where such money was identifiable. Although this may reflect a concern for the equal treatment of creditors in insolvency, it sits less easily with the FSA's regulatory objectives.

### **Conclusion**

Although the proposals in the CP are largely sensible and address some of the issues raised by the failure of Lehman, some of them are unnecessarily burdensome and a number of the fundamental problems, highlighted in the Lehman judgments, remain. Client money, although subject to a statutory trust from the moment it is paid to a firm, is not given the full protection of

CASS unless and until it is segregated into a client money account by the firm. The operation of the alternative approach can still give clients intra-day (or in the case of Lehman intra-weekend) credit risk with respect to that money unless, which is usually impossible, the money can be traced back to a specific bank balance. Firms that operate the alternative approach have been left in doubt over their legal and regulatory position, because client money that has not yet been segregated must be held by the firm as trustee with the consequential fiduciary duties that this entails. However, the alternative approach may be the only practicable option for complex prime brokerage operations.

The FSA also plans to carry out further work in 2010 on the use of title transfer arrangements, which currently restrict the availability of client money protection in prime brokerage and custody agreements.

The Lehman judgments send a clear message to clients: choose who holds your client money carefully because there is little protection offered to clients by the rules if a firm makes errors that lead to client money not being segregated correctly. Clients have already stepped up their due diligence and monitoring of firms' client money and asset segregation procedures, as has the FSA. This trend looks set to continue, with prime brokers offering daily reporting to clients and some choosing to operate bankruptcy-remote special-purpose vehicles to hold client money and assets.

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