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Client Assets and Money in the Post-Lehman World

1 Introduction

The first statutory objective of the Financial Services Authority ("FSA"), as mandated by the Financial Services and Markets Act 2000 ("FSMA") is "maintaining confidence in the financial system".[1] This is a legislative recognition of the obvious truth that a financial system can survive only where it has the confidence of its stakeholders. This is the case at both a micro and a macro level: an individual who does not have confidence in the stability of a bank is unlikely to make (or leave) a deposit there; market participants who do not believe that their investments will be treated in accordance with a clear, fair and certain set of rules will be likely to look elsewhere for investment opportunities.

In its *Client Money and Assets Report*, published in January 2010, the FSA highlighted the importance of clients having confidence that their client money and assets are safe and will be returned within a reasonable time frame in the event that a firm becomes insolvent. The FSA identified the protection of client money and assets as a fundamentally important part of regulation and indicated its intention to intensify its oversight of client asset and money protection. This would manifest itself in both targeted regulatory enforcement actions and revisions to the client asset and money rules.

Implicit in both the need for and the content of the *Client Money and Assets Report* was a recognition of, and an attempt to make good, the damage that had been done to confidence in the FSA's existing rules for the custody of client assets and money in the aftermath of the financial crisis.

In the early summer of 2010, the Court of Appeal adjudicated in a dispute between creditors of the collapsed Lehman Brothers International

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(Europe) which centred on the correct interpretation of the FSA's client money rules and which highlighted a number of ambiguities and uncertainties in those rules. This *Bulletin* examines that decision and considers its implications both for the individuals and firms who place their assets or money with FSA-authorised firms and for those firms which themselves hold client assets or money. The *Bulletin* also describes the current requirements of the FSA's client asset and money rules in the light of that Court of Appeal decision and considers whether recent enforcement action and proposals made by the FSA for the enhancement of those rules have sufficient polish to restore the FSA's tarnished client assets and money regime.

2 The Lehman client money appeal

2.1 Background

On the morning of Monday September 15, 2008 Lehman Brothers International Europe ("LBIE") was placed into administration. LBIE was the principal trading subsidiary in the United Kingdom of Lehman Brothers Holdings Inc, which itself filed for Chapter 11 protection in the United States later the same day. The insolvency of Lehman Brothers was, of course, a significant event of the wider financial crisis and would have multiple and significant repercussions.

One such repercussion was an immediate and difficult problem for the partners of PricewaterhouseCoopers appointed by the court to act as administrators of LBIE (the "administrators"). The entry into administration of LBIE was what is known in the FSA's client money rules as a primary pooling event, requiring LBIE (or its administrators) to treat the "client money held in each client money account of the firm" as pooled and to distribute that pool to clients in the order specified by the rules.

The stakes, of course, were very high. The administrators had initially identified a client money pool of approximately $2 billion. Clients who believed that LBIE held their money as client money wanted it back. The administrators were placed under significant pressure: surely the purpose of the client money rules was to segregate and protect client money in exactly these circumstances and to allow its prompt return to the rightful owners?

Unfortunately, the administrators found that they were unable to determine with any certainty either the amount of client monies held by LBIE to be pooled, or, once determined, who was entitled to participate in or receive money from that pool. A factor in this uncertainty was, no doubt, the fact that, as one of the largest investment banks operating in the United Kingdom prior to its collapse, LBIE undertook multiple (many hundreds, if not thousands) and complex financial transactions on a daily basis.

The administrators discovered LBIE's business to be so complex and its record keeping, certainly in the days immediately preceding its administration, so inadequate that it was extremely difficult to identify exactly how much client money

LBIE itself thought that it held immediately prior to its administration. There was also a gap of three days between LBIE's final calculation of the client monies that it held and its entering administration. LBIE operated what is known in the client money rules as the "alternative approach" to the receipt and segregation of client funds. That is, rather than being paid directly into segregated client accounts, monies received from clients were paid into an account or accounts of LBIE and then, following a reconciliation of client monies undertaken as at the close of business on the preceding day, an amount representing the balance of client monies to and from LBIE was either credited to or deducted from its segregated client accounts. LBIE undertook its last reconciliation of client funds on the Friday before it entered insolvency and this reconciliation (and the resultant balance of the client money accounts) reflected the client money position of LBIE at the close of business on the preceding Thursday evening. Accordingly, any money received by LBIE after the close of business on the Thursday evening was held in its house accounts, whether or not that money should have been held as client money.

However, the administrators and the advisers also found that there was a lack of certainty as to how the client money rules themselves should be interpreted. The FSA rules impose a statutory trust over client money held by an authorised firm with the effect that client money is owned and held by the firm in its capacity as trustee for the benefit of its clients. The administrators came to realise that they could not be certain as to whether the rules required that money should be held on trust the moment that it was received by the firm or only when it was actively placed in a segregated account. Similarly, what was actually meant by the term "client money account" which was used in the rules? It was not defined, so the question arose as to whether it meant the identifiable accounts into which LBIE deposited segregated client money or, instead, any account of LBIE which contained client money. Similarly, once the pool of client money had been determined, how were the administrators to decide which clients were entitled to receive a share of it? Was it those clients who could prove that they had paid money to LBIE to be held in its client money accounts, or was it wider than that? It was necessary to answer these questions in order for the administrators to determine how large the LBIE client money pool was and who was entitled to share in it. However, on May 1, 2009 the administrators effectively threw their hands into the air and applied to the High Court in London for directions as to how they should apply the client money rules to the assets of LBIE.

The High Court delivered its judgment on these issues in December 2009; however, its decision was referred to the Court of Appeal. It is not yet clear whether the Court of Appeal's decision, delivered on October 2, 2010, will itself be appealed to the Supreme Court. For the time being Arden L.J.'s judgment in *CRC Credit Fund Ltd, Lehman Brothers Inc, Lehman Brothers Finance AG and Lehman Brothers Holdings Inc v GLG Investments Plc Sub-Fund: European Equity Fund, Hong Leong Bank Berhad*[2] (referred to for the remainder of this *Bulletin* as the "Court of Appeal judgment") provides the definitive guide to understanding these issues and the application of the client money rules more generally.

2.2 Interpretation of the client money rules

In its judgment the Court of Appeal directs itself that, in interpreting the client money rules, it should "at least … start out with the view that the drafter intended to create a coherent scheme even if this is ultimately disproved in certain respects".[3] This comment reflects an implicit annoyance in the Court of Appeal judgment that the client rules had not been sufficiently well drafted to allow the administrators to understand the intent of the rules and to promptly distribute client assets (although this annoyance is tempered by an acknowledgment of the complexity of LBIE's circumstances).

The Court of Appeal judgment acknowledges that the FSA, as the relevant competent authority, chose the client money rules as the mechanism to give effect in the United Kingdom to the provisions of the Markets in Financial Instruments Directive[4] and its implementing directives and regulations (together in this *Bulletin*, "MiFID") which required financial services firms to take steps to protect client money (principally through the segregation and separation of separate funds). Accordingly, the Court of Appeal determined that it should interpret the client money rules in such a way as to give effect to the provisions of MiFID so far as possible.

The Court of Appeal also directs itself that, as the FSA is required by s.138(1) of the Financial Services and Markets Act 2000 to exercise its rule-making powers with the purpose of protecting consumers, the court should "lean against interpretations which result in legal 'black holes'"[5] and should seek to give effect to that purpose. The Court of Appeal therefore allows itself to assume that the FSA would have been aware that authorised firms had, in the past, made serious mistakes in implementing (or failing to implement) predecessor rules to the FSA's client money rules and that, therefore, the FSA would have sought to design the client money rules so as to offer protection to investors even where mistakes had been made in the implementation of those rules by an authorised firm.

Furthermore, the Court of Appeal also found, for the purpose of interpreting the client money rules, the traditional equitable approach, where the instrument creating a trust is silent to what is to happen in particular circumstances, that nothing would happen when those circumstances arise would not be sufficient. The Court of Appeal therefore held that, in circumstances where a statute creates a trust but where, as in the case of the trust created by the client money rules, the "provisions of that trust are … rudimentary [and the] trust is created with little elaboration", the court is required to rely on the general principles of trust law to fill in the gaps.[6]

2.3 The questions answered by the Court of Appeal

The Court of Appeal posed to itself and answered four specific questions as to how the client money rules should be interpreted and applied. The questions asked and the answers given are described below.

2.3.1 Does the statutory trust created by the client money rules take effect upon the receipt, or only upon the segregation, of client money?

The Court of Appeal's judgment is clear that the statutory trust arises the moment that a firm receives client money.

The fact that the provision of the client money rules, which creates a statutory trust over client money (see CASS 7.7.2R as discussed below), refers to both "receiving" and "holding" should not be construed as meaning that the trust is only created on completion of the second stage. Instead, it ensures "that the statutory trust applies both to money which has been received and to money which is held by the firm".[7]

The effect of this finding is that the statutory trust applies not just to money which has been segregated and is held in a designated client money account, but also to client money which has not yet been segregated. This permits a claimant "to pursue a proprietary claim to his money and to prevent the firm from using the money, so long as it is identifiable, to pay its own creditors in the event of an insolvency".[8]

The Court of Appeal dismissed arguments to the effect that the client money rules should not be interpreted as creating a trust on receipt of the client money as this was not expressly required by the provisions of MiFID. The Court of Appeal noted that, in fact, MiFID requires, at art.13(8), authorised firms to make "adequate arrangements to safeguard clients' rights and … prevent the use of client funds for its own account" and that the total effect of MiFID was to require the United Kingdom to require firms to take effective measures to protect and safeguard clients' rights in their money. In the Court of Appeal's judgment this requirement to take effective measures to protect and safeguard clients' money was given effect by the creation of the statutory trust in CASS 7.7.

2.3.2 Following the insolvency of an authorised firm, do the client money rules require that only segregated client money be pooled or that client money be pooled wherever it is found?

The Court of Appeal found that "CASS 7 as a whole demonstrates that what was intended and indeed achieved by CASS 7.9.6 was a pooling of all segregated accounts and house accounts".[9] That is, the effect of CASS 7 is to pool identifiable client money wherever it is found and not just in bank accounts into which segregated client money has been deposited.

The Court of Appeal's judgment on this issue focused on the interpretation of CASS 7.9.6R and in particular the provision that, if a primary pooling event occurs, "client money held in each client money account is treated as pooled". It is worth noting that this provision was deleted from the client money rules on December 31, 2008; however, identical wording can now be found at CASS 7A.2.4R(1).

The Court of Appeal notes that the crucial phrase "client money account" is not defined in the FSA's Rules. Further, CASS 7.9.6R did not use the terms "client account" or "segregated client account", which would clearly have indicated that it was intended that the pooling would apply only to money held in segregated accounts. Instead, the Court of Appeal finds that as the term "client money" is not restricted in its definition to money contained in client money accounts, the FSA, in drafting the client money rules, must have intended that the term "client money account" be understood as being more than merely the accounts containing segregated monies.[10] Furthermore, the Court of Appeal considered that to interpret CASS 7.9.6R in any other way would defeat the purpose of the statutory trust created by CASS 7.7: "it is unlikely that a single trust would treat the beneficiaries in entirely different ways, especially if only one form of treatment is expressed in the terms of the trust, here CASS 7".[11]

The Court of Appeal does not accept arguments that the FSA's guidance in the client money rules supported a narrower view. The Court of Appeal found that the FSA's guidance in that:

> "a client's main claim is for the return of client money held in a client bank account. A client may be able to claim for any shortfall against money held in a firm's own account. For that claim, the client will be an unsecured creditor of the firm."

was either inaccurate or incomplete. The Court of Appeal noted that this guidance did not deal with claims for identifiable money held in house accounts. In any event, the Court of Appeal did not consider that it was necessary to attach any weight to this provision as it was merely guidance and therefore not binding on the court.[12]

2.3.3 *Is the basis for sharing in the client money pool the amount which ought to have been segregated for each client (referred to in the judgment as the "claims basis"), or the amount which was in fact segregated by the failed firm (the "contribution basis")?*

On this issue, the Court of Appeal held that client's share of the client money pool should be calculated by reference to the amount of money that the failed firm should have segregated for the client, rather than the amount of money that was in fact segregated. The Court's finding focused on language previously located in the now deleted CASS 7.9.6R, but identical language to which can now be found at CASS 7A.2.4(2). The Court of Appeal determined that the underlying concept of "client money entitlement" was one of contractual entitlement. The effect of this judgment is that

> "some clients will benefit from a distribution even if they have no proprietary claim to client money. However, [the FSA had determined in the mechanism of the CASS rules] that the failure of the firm should be treated as a common misfortune in which those who had claims to the recovery of client money should share without distinction."[13]

The impact of this aspect of the Court of Appeal's judgment is profound. It does not matter that a client can point to a particular portion of money and say "I placed that money there; it is mine." All clients whose money should have been segregated are entitled to share in the pool of identified money.

2.3.4 *When does money which the firm owes to a client become "client money"?*

On this issue, the Court of Appeal determined that the term "client money" does not include sums due and payable by an authorised firm, but which has not yet been set aside for that purpose.

On this point, the court distinguished between money that had been received by the authorised firm (whether directly from the client or a third party) and which it held, or should have held, for the client and money which, as a result of a contractual obligation (such as the requirement to pay a manufactured dividend pursuant to a securities lending arrangement), the firm owed to the client but had not yet paid.

2.4 Significance of the Court of Appeal judgment

The Court of Appeal's judgment, of course, had an immediate impact on the parties involved, not least because, on the second and third questions described above, the Court of Appeal overturned the lower court. By determining that the client money rules require the pooling of client money wherever it is found and by allowing each client whose money should have been segregated to participate in the total pool of client money, the Court of Appeal both increased the size of LBIE's pool of client money (and thereby reduced the amount of assets available to general creditors) and increased both the number and size of claims on that pool. It is not yet clear whether any party to the proceedings will appeal to the Supreme Court. In the meantime, the administrators will now be working to recalculate the size of the LBIE client money pool and to determine who has a valid claim on that pool in accordance with the Court's findings.

The judgment also has a wider impact. Authorised firms subject to the client money rules, and clients of those firms, will now need to ensure that they understand those rules in the context of the Court of Appeal judgment. The next section of this *Bulletin* describes the client asset and money rules in that light.

The Court of Appeal implicitly criticised the FSA for the ambiguities and inconsistencies that its judgment discovered in the client money rules. It additionally noted that the client money rules, which are intended to offer clients protection, did not require firms that had adopted the "alternative approach" to client money segregation to notify their clients that they were doing so and of the additional risk that the clients would be subject to as a result.

3 The client asset and money rules

3.1 Introduction

Principle 10 of the FSA's Principles for Businesses requires that:

> "A firm must arrange adequate protection for client's asset when it is responsible for them."

The generality of this Principle is expanded upon by the rules and guidance set out in the Client Assets Sourcebook ("CASS") of the FSA's Handbook.[14]

An understanding of CASS is necessary not only for those firms that are subject to it but also for firms and institutions such as asset managers, who hold significant amounts of their own assets at such firms.

This part of the *Bulletin* summarises the client asset and money rules as they apply to investment firms. The *Bulletin* does not address those parts of CASS that apply only to insurance mediation activities.

The FSA reorganised the CASS handbook on January 1, 2009, shortly after the administration of LBIE. A significant part of the Court of Appeal's judgment was devoted to that part of the client money rules which described the way in which money should be distributed following an authorised firm's failure. Prior to 2009, these rules were found in CASS 7.9, but are now located in CASS 7A. However, the substance of the wording under consideration by the FSA remains the same.

3.2 Important definitions

As in any discussion of the FSA's rules, it is difficult to avoid the use of the FSA's own defined terms when considering the terms of CASS. Some of the key defined terms used in CASS are summarised below. Where appropriate, this *Bulletin* adopts the convention of the FSA Handbook and, where it uses the terms discussed below, italicises them.

3.2.1 MiFID business

As one would expect, the term "*MiFID business*" is intended to capture any activity that is subject to the provisions on MiFID and is defined to include the investment services and activities listed in s.A of Annex I to MiFID.[15]

3.2.2 *Financial instruments*

The term "*financial instruments*" is derived from MiFID and captures the instruments listed in s.C of Annex I to MiFID.[16]

3.2.3 *Designated investments*

The term "*designated investment*" is defined to include life insurance policies; shares; debentures; government and public securities; warrants; certificates representing securities; units in collective investment schemes; stakeholder pension schemes; personal pension schemes; options; futures; contracts for difference and rights to or interests in instruments.

3.2.4 *Safe custody asset*

A "*safe custody asset*" is, in the context of *MiFID business*, a *financial instrument* and, in respect of all other types of assets, a *designated investment* which does not belong to the relevant authorised firm but for which the firm or its nominee is accountable.

3.2.5 *Qualifying money market fund*

A "*qualifying money market fund*" is a UCITS fund, the primary investment objective of which is to maintain the value of the investors' initial contributions, that invests exclusively in money market instruments which have been rated with the highest available credit rating by every credit rating agency that has rated the instrument and which offers daily liquidity.

3.3 CASS 1: Application and general provisions

CASS is broad both in its scope and its application.

The effect of CASS 1.2.2R and 1.3.2R is that every authorised firm (apart from firms which have passported into the United Kingdom from other EEA jurisdictions and which remain subject to the client asset rules of their home regulator,[17] open-ended investment companies and UCITS operators) are subject to the provisions of CASS. CASS applies both to activities carried on in and from the United Kingdom and to branches established by UK-authorised firms (other than by insurers) in other EEA jurisdictions. Even where a firm's business is such that they do not hold client assets or money in the ordinary course of business, it will need to be aware of the requirements of the rules in CASS: for example, CASS 1.4.2G confirms that the custody chapter, client money chapter and the collateral rules will apply to firms engaged in stock lending or corporate finance business. At the very least, firms need to understand in what circumstances assets or money can be treated as not being that of the client.

CASS makes very limited distinction between the classification of clients. For the purpose of CASS, eligible counterparties are required to be treated as professional clients.[18] Retail clients are offered only a limited level of additional protection over and above that enjoyed by professional clients. The CASS rules contain a specific reminder that the requirement, set out in COBS 2.1.1R, that a firm act at all times honestly, fairly and professionally in the best interests of a retail client applies to the firm when handling a retail client's assets or money. However, in practice this offers no more additional protection (and imposes no additional burden on the firm) than Principle 6 of the FSA's Principles for Businesses which requires a firm to pay due regard to the interests of its customers and to treat them fairly. Principle 6 is applicable when dealing with professional clients. However, CASS does make provision for limited additional disclosure to be made for retail clients. For example, the CASS rules require that a retail client be notified where his client money is transferred to a third party (see CASS 7.5.2R), or where money transferred to an authorised firm will not be treated as client money because it is collateral (see CASS 7.2.7G).

Although CASS has no direct application to a firm's appointed representatives or tied agents, anything done or omitted to be done by an appointed representative or tied agent will be treated by the FSA as having been done or omitted to be done by the firm as a result of it having accepted regulatory responsibility for the appointed representative.[19] Authorised firms should therefore ensure that any client money received by their appointed representatives is either paid into its *client bank* *account* no later than the business day after receipt, or that it is forwarded to the firm so that it arrives within three business days and can be dealt with by the firm as client money in the normal way (see CASS 7.4.24G).

A further effect of CASS 1.2.2R is that, unless specifically stated to the contrary in a particular CASS rule, CASS will not apply to a firm in the conduct of its unregulated business. Accordingly, to the extent that a particular activity falls within an exclusion provided in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "RAO"), the activity will not generally be subject to the provisions of CASS (CASS 1.2.7G reminds firms that the definition of "*designated investment business*" includes activities that would otherwise fall within the exclusion from dealing in investments as principal in art.15 of the RAO. Therefore, even to the extent that a firm does not hold itself out as dealing in investments as principal, the rules in CASS will apply to any transaction in investments undertaken by a firm with a customer).

3.4 CASS 3: Collateral

3.4.1 Application

The stated intention of CASS 3 is "to ensure that an appropriate level of protection is provided for those assets over which a client gives a firm certain rights". The CASS rules provide that, where legal ownership of an asset is transferred to the firm (notwithstanding that such transfer is subject to a contractual obligation to return the asset in specified circumstances), the client transferring the asset will benefit from a significantly lower level of regulatory protection. It is typically the case that, where an asset is posted as collateral, the receiving firm will take ownership of the asset or will otherwise have the right to "re-hypothecate" the asset or use it for its own purposes (subject to a contractual requirement to redeliver an equivalent asset at the appropriate time). In such cases, the collateral rules in CASS 3, which offer limited meaningful protection to the firm transferring the assets, will apply.

By contrast, the collateral rules will not apply where the receiving firm has only a bare security interest over the client's assets (e.g. a pledge or a charge). Where there is a bare security interest, the client will continue legally to own the relevant asset until the security interest is exercised or crystallises on the client's default. In such cases, the custody or client money rules (as discussed below) will apply.

By way of an example of the arrangements that the collateral rules in CASS 3 are intended to apply, the FSA gives the taking of collateral by a firm pursuant to English law ISDA arrangements (which provide for a full transfer of title of assets posted as collateral). However, CASS 3 will also apply to any arrangement where the receiving firm has a right to use or re-hypothecate assets transferred to it as collateral. Accordingly, assets transferred as collateral pursuant to prime brokerage or securities lending arrangements will typically fall into this category. Anecdotal evidence suggests that this may not have been fully understood before the collapse of LBIE: it appeared to be the case that many asset managers, who perhaps had not reviewed the detail of the prime brokerage agreements with LBIE since gratefully accepting the terms offered when setting up their business, had not understood (or, in more positive economic times, had not recognised) the significance that, when collateral was posted to LBIE, it ceased to belong to the transferring party and, as a result, became simply an asset of LBIE that was available to its general creditors on its insolvency.

Authorised firms, which are more likely to post collateral rather than receive it (e.g. asset managers) should, if they have not already, revisit their brokerage arrangements to ensure that they understand their credit risk exposure to brokers and securities lenders and to consider whether this risk can be managed more effectively (perhaps by renegotiating the terms of the relevant agreements or by adjusting the amount of collateral that is posted, i.e. posting only that which is required and holding the remaining assets under management with an institution who will hold them in accordance with the custody chapter or client money rules of CASS).

3.4.2 Requirements

An authorised firm that receives an asset on the understanding that the firm is permitted to use the asset as its own and to treat it as if full legal title in that asset and the associated property rights have been transferred by the client to it is required by CASS 3 only to ensure that "it maintains adequate records to enable it to meet any future obligation including the return of equivalent assets to the client" (see CASS 3.2.2R). Assets held pursuant to the collateral rules are not required to be held in a special account or otherwise segregated. The authorised firm's only responsibility is to ensure that it has properly recorded the obligation to return an equivalent security when due.

3.5 CASS 6: Custody rules

3.5.1 Application

The circumstances in which the custody rules will apply, as set out in CASS 6.1.1R and 6.1.1BR, are so broadly drawn it is often easier to understand the application of the custody rules by reference to the exceptions rather than the rule.

CASS 6.1.1R provides that the custody rules will apply in two broad circumstances. First, the custody rules will apply when an authorised firm holds *financial instruments* that belong to a client in the course of *MiFID business*. Secondly, the custody rules will also apply when an authorised firm receives or holds a *designated investment* on behalf of a client. The custody rules can also potentially apply to assets that are not in themselves *designated investments*, but which are held in the same portfolio as designated investments on behalf of the client (so where a firm holds for a client both shares and a document certifying, for example, the client's part ownership of a horse, the custody rules can apply to the latter as well as to the former) (see CASS 6.1.1A G).

Therefore, unless one of the exemptions described below applies (or unless the authorised firm is an operator of a regulated collective investment scheme, a personal investment firm, a trustee or a depository, in which case the custody rules are either excluded or limited in scope), an authorised firm engaged in *MiFID business* (i.e. any investment manager, investment adviser, broker whether dealing as principal or as agent, securities underwriter, or operator of a multilateral trading facility), or that otherwise receives and holds an investment on behalf of a client (or potentially any other form of asset) will be subject to the requirements of the custody rules.

However, CASS 6 also describes a series of circumstances in which the custody rules do not apply to an authorised firm in the course of its *MiFID business*. The custody rules will not apply to a firm where:

- the authorised firm receives money (in any form, e.g. cash, cheque, electronic transfer or other form of payable order), in which case the client money rules (as discussed below) are likely to be relevant;

- the authorised firm receives a *safe custody asset* in the course of business carried on in its own name but on behalf of a client, provided that that is required by the very nature of the transaction (i.e. where the authorised firm, acting as principal, borrows stock from a client pursuant to a stock lending agreement) and the client has agreed that the custody rules will not apply in these circumstances (see CASS 6.1.4R);

- the client transfers full ownership of a safe custody asset to the authorised firm for the purpose of securing or otherwise present or future, actual, contingent or prospective obligations (as discussed above, in these circumstances the collateral rules, which offer clients comparatively little meaningful protection, are likely to apply) (see CASS 6.1.6R);

- the authorised firm receives a safe custody asset in the course of a delivery versus payment transaction through a commercial settlement system and the asset is due to either the client or the firm, as appropriate, within one day of the payment obligation being fulfilled (provided that if the authorised firm does not make delivery or payment within three days of the execution date, the asset will then be treated in accordance with the custody rules) (see CASS 6.1.12R); or

- the authorised firm handles the asset on a temporary basis, provided that it is not handled for longer than is necessary (typically one business day) (see CASS 6.1.15G).

If an asset received by an authorised firm does not fall into one or more of the exemptions outlined above, the custody rules will apply.

3.5.2 Requirements

The principal requirements applicable to an authorised firm holding safe custody assets are set out in CASS 6.2. The core rule is that the firm must make adequate arrangements so as to safeguard clients' ownership rights over the assets (especially in case of the firm's insolvency) (see CASS 6.2.1R). In most circumstances, this rule will be satisfied where the authorised firm has, in accordance with CASS 6.2.3R, effected registration or recording of legal title to the asset in the name of:

- the client (unless the client is an authorised firm acting on behalf of a third party, in which case the asset can be recorded in the name of the third party); or

- a nominee company (provided that the nominee company is controlled by the authorised firm or its affiliate and the authorised firm accepts responsibility to the client for the nominee's compliance with the custody rules (see CASS 6.2.4R) or, where the nominee is controlled by a third party (other than a regulated investment exchange), the firm has complied with the requirements of CASS 6.3 (which are discussed below)); or

- a third party, provided that the firm has complied with the requirements of CASS 6.3 (which are discussed below).

Where the safe custody asset is subject to the law or market practice of a jurisdiction other than the United Kingdom and provided that the authorised firm "has taken reasonable steps to determine that it is in the best interests of the client", the firm may arrange for an asset to be recorded in either its own name or the name of a third party subject to giving written notice to the client of its intention to do so (and, in the case of a retail client whose asset is to be recorded in the name of the firm, obtaining the written consent of that client) (see CASS 6.2.3(3) and (4)). An authorised firm that intended to rely on this provision would be well advised to obtain a legal opinion from a reputable law firm in the relevant jurisdiction to the effect that recording assets in this way would be in the best interests of the client.

The custody rules provide that an authorised firm may register or record its own designated investments in the same name as safe custody assets belonging to its client. However, if an authorised firm chooses to do so it must identify those assets in its records separately from assets it holds on behalf of clients (or, if the assets are held outside the United Kingdom, take reasonable steps to determine that this is in the client's best interests and notify it accordingly). Notwithstanding the proviso that the authorised firm must ensure that the firm's own assets are separately identified in its records, allowing an authorised firm to record its own and its client assets in the same name will inevitably cause an insolvency practitioner problems and will delay the return of assets in the event of an insolvency of an authorised firm.

Additionally, an authorised firm must ensure that it puts in place appropriate systems to ensure that safe custody assets cannot be used on its own account (unless the firm has the client's express consent and has complied with the specific requirements of CASS 6.4, as discussed below) (see CASS 6.2.1R) and that it has adequate organisational requirements to minimise the risk of loss or diminution of clients' assets, or the clients' rights in respect of those assets, through misuse of the assets, fraud, poor administration, inadequate record keeping or negligence (see CASS 6.2.2R). Firms should be aware that, as a result of this rule, even where the firm itself has been subject to a fraud (e.g. an employee misappropriating assets), the firm can be subject to disciplinary action where the FSA determines that it did not have in place appropriate systems to detect and prevent that fraud.

Where the authorised firm holds a non-investment asset within the same portfolio as a safe custody asset for a client, the firm must apply the custody rules to those assets "in a manner appropriate to the nature and value of those custody assets" (see CASS 6.1.1BR).

3.5.3 CASS 6.3: Depositing assets and arranging for assets to be deposited with third parties

Where a firm either deposits safe custody assets with a third party or arranges the registration of a safe custody asset through a third party, it is required to exercise all due skill, care and diligence in the selection and appointment of any such third party (see CASS 6.3.1R). Such due diligence must take into account the expertise and market reputation of the third party, any legal requirements or market practices related to the holding of those safe custody assets that could adversely affect clients' rights, the arrangements that the third party has in place for safeguarding and holding the assets, current industry standard reports (e.g. the *Financial Reporting and Auditing Group (FRAG) 21 report*), the capital or financial resources of the third party, the credit rating of the third party and any other activities undertaken by the third party or its affiliates (see CASS 6.3.1R (3) and 6.3.2G). An authorised firm must record the basis on which it has satisfied itself that the third party is an appropriate person to appoint and must retain such records for at least five years after the third party ceases to hold safe custody assets belonging to the firm's clients.

Furthermore, where a firm deposits safe custody assets with a third party, it must periodically review the continued appointment of that third party (see CASS 6.3.1R(1)). Accordingly, the diligence requirements described above must be satisfied not only on appointment of the third party but thereafter on a regular basis. In most instances, the FSA would not consider anything less than an annual review as acceptable.

CASS 6.3 also requires authorised firms to ensure that the contractual arrangements with the third party provide for the safe custody assets to be identifiable separately (by means of differently titled accounts) from any assets held by the third party that belong to the authorised firm or which belong to the third party (see CASS 6.3.2R). In negotiating its contractual arrangements with the third party, the authorised firm should seek to ensure that the title of the account with the third party should indicate that the assets held within it do not belong either to the authorised firm or the third party, that the third party is restricted from exercising any lien, right of retention or right of sale over the safe custody assets and that the third party is explicitly liable in the event of any loss of a safe custody asset (see CASS 6.3.3R).

Unless the third party is domiciled in a country outside the European Economic Area which does not specifically regulate the safekeeping of safe custody assets, an authorised firm may only deposit safe custody assets with a third party who is subject to such regulation (see CASS 6.3.4R (1)). Where an authorised firm wishes to deposit assets with a third party in a country without such regulation it may only do so where the nature of the safe custody assets requires them to be held in that country or where the client makes a specific request for the assets to be held in that country (see CASS 6.3.4R (2)).

3.5.4 *CASS 6.4: Use of safe custody assets*

An authorised firm must not use a safe custody asset for its own account or for the account of any other person unless the client has given its prior consent to the use of those assets on specified terms (such consent may be for a specific transaction or may restrict the use of the assets for specific types of transactions on specific terms (see CASS 6.4.1R)). Where a safe custody asset is held in an omnibus account, it must not be used for the authorised firm's own account or for the account of any other person unless *each* client who owns assets in that omnibus account has provided consent (as above, such consent may be for a specific transaction or may restrict the use of the assets for specific types of transactions on specific terms), or unless the firm has in place systems and controls that are able to ensure that only assets belonging to clients that have given such consent are used for the account of the authorised firm (see CASS 6.4.1(2)R).

3.5.5 *CASS 6.5: Records, accounts and reconciliations*

A firm that holds client assets is required to "keep such records and accounts as necessary to enable it at any time and without delay" to identify safe custody assets and to distinguish those assets from assets belonging both to other clients and to the firm itself (see CASS 6.5.1R). Those records must be accurate and correspond to the safe custody assets held for clients (see CASS 6.5.2R).

In order to ensure that its records of client assets are accurate, an authorised firm must undertake reconciliations of its internal records "as often as is necessary" and must additionally conduct "on a regular basis" a reconciliation between its internal records and the records of third parties with whom the safe custody assets are held. Both internal and external reconciliations should take place "as soon as reasonably practicable" after the date to which the reconciliation relates (see CASS 6.5.4 and 6.5.6G). Reconciliations of records should, where possible, be undertaken by a person who is not involved in the production or maintenance of the records (see CASS 6.5.9G).

The FSA provides no definitive guidance as to what "as often as necessary" or "regular basis" mean. Accordingly, authorised firms must assess for themselves, normally on the basis of the level of turnover within a safe custody account, how regularly reconciliations should be undertaken to ensure that its records are accurate. However, the FSA does suggest that, as a minimum, a firm should ensure that all safe custody assets are counted and reconciled every six months.

The CASS rules allow authorised firms a degree of flexibility in the methodology used for reconciliation; however, if a method other than "total count" is used, the firm must provide to the FSA written confirmation from its auditor that it has in place "systems and controls which are adequate to enable it to use the method effectively" (see CASS 6.5.5R).

Any discrepancy which is identified during a reconciliation process should be made good by the authorised firm wherever there are reasonable grounds for concluding that the firm is responsible for the short fall (see CASS 6.5.10R).

3.6 CASS 7: Client money rules

3.6.1 Application

The client money rules apply to any firm that receives money from, or holds money for, or on behalf of, a client in the course of or in connection with its *MiFID business* or in respect of an agreement, the making or performance of which by any party to it constitutes a regulated activity (see CASS 7.1.1R). The client money rules do not apply to a banking institution in respect to money that it holds as a deposit (see CASS 7.1.8R); however, where a bank offers its customers a service that constitutes *MiFID business*, for example a securities broking account, the client money rules can apply.

3.6.2 What is client money?

For these purposes, "money" means any form of money including cash, electronic balances, cheques and any other form of payable order. However, money does not include coins which are held, by agreement with the client, for the intrinsic value of the metal rather than their face value (e.g. gold sovereigns) (see CASS 7.1.14R).

It is important to note that client money does not need to be paid to the authorised firm by the client; it is sufficient that it is held by the firm *for the benefit* of the client. Therefore, amounts paid to the firm by third parties for the account of the client are capable of being client money. The Court of Appeal's judgment clarified that money is not client money simply because it is owed by the firm to the client pursuant to a contractual arrangement. For example, if the firm and the client have entered into a securities lending arrangement pursuant to which a manufactured dividend becomes due, that due amount does not become client money until it is actually set aside for this purpose by the firm.

The Court of Appeal made this finding notwithstanding the guidance of the FSA at CASS 7.2.13G, in which it is said that a firm should treat a commission rebate as client money when it becomes due and payable to the client. The Court of Appeal felt able to distinguish this guidance from its finding on the grounds that the term "commission rebate" (which is not defined in the FSA's rules) may have been intended to mean rebates payable by third parties to the firm for the benefit of its client.[20]

However, money will cease to be client money in certain specified circumstances. Most obviously, money will cease to be client money when it is paid out in discharge of the firm's fiduciary duty. Accordingly, where the money is paid (i) to the client or to its representative; (ii) to a third party on the instruction of a client; (iii) into a bank account of the client (other than an account which is also in the name of the authorised firm); or (iv) to the authorised firm itself where it is due and payable to the firm, it will cease to be client money (see CASS 7.2.15R). Where money is paid out by cheque or other payable order, it may only cease to be treated as client money once that cheque or order is presented and paid by the bank (see CASS 7.2.17R).

Unless the money has been identified in a reconciliation process, as discussed below, as excess money in the client bank account, money may only be paid by the authorised firm from the client account to itself where it becomes "properly due and payable to the firm for its own account" (see CASS 7.2.9R). Accordingly, where an amount becomes due to the firm in accordance with the terms of its contract with the client and the terms of that contract permit the firm to withdraw amounts from the client account for the purpose of paying itself, the firm may withdraw that amount and it will cease to be client money.

Additionally, money will cease to be client money (or, if it had not in the first place been client money, will not become client money) where "full ownership" of that money is transferred to the firm for the "purpose of securing or otherwise covering present or future, actual or contingent obligations" (see CASS 7.2.1R). The phrase "full ownership" implies that money will only cease to be client money where the receiving firm has the right to use that money as it sees fit. Accordingly, the FSA suggests in additional guidance that, in fact, notwithstanding that a firm may have a right to transfer money from a client account to its own account in certain circumstances, the money should only cease to be client money when that right is exercised (see CASS 7.2.5G). CASS 7.2.7G suggests that a firm, in order to comply with the requirement to deal with a retail client fairly, honestly and professionally in COBS 2.1.1R, should ensure that, where ownership of a retail client's money is transferred to the firm, for the purpose of securing or covering the client's obligations, an equivalent transfer is made back to the client if the provision of collateral is no longer necessary and there is a reasonable link between the timing and the amount of the collateral transfer and the obligation that the client owes or is likely to owe to the firm. Nevertheless, although this guidance is offered in the context of a rule applicable to dealings with retail customers only, bearing in mind the more general application of the Principle 6 Requirement to treat *all* customers fairly, authorised firms would be ill advised to consider that it offered an opportunity to deal with professional clients' money in a way materially different from that of retail clients.

Similarly, money is not required to be treated as client money in respect of a delivery versus payment transaction through a commercial settlement system, and the money is due to either the client or the firm, as appropriate, within one day of the payment obligation being fulfilled (provided that if the authorised firm does not make delivery or payment within three days of the execution date, the money will then be treated in accordance with the client money rules) (see CASS 7.2.8B).

Prior to the implementation of MiFID in November 2007, the client money rules provided that a professional client could opt out of the client money rules. This opt-out is still available, but only to the extent that client money is received or held in connection with that is not *MiFID business* and therefore has limited usefulness for most investment firms. Where the professional client opt-out is utilised, it is necessary to obtain written confirmation from the client that he understands that:

- his money will not be subject to the protections conferred by the client money rules;
- as a result his money will not be segregated from the assets of the authorised firm and will be available to be used by the authorised firm for its own purposes; and
- in the event of the firm becoming insolvent, he will not have a preferential claim to his money and will rank only as a general creditor of the firm (see CASS 7.1.7(C)R).

It is still sometimes the case that an agreement that pre-dates MiFID (and even rarely post MiFID) will purport that money held by an authorised firm for a professional client will not be treated as client money. However, where that money is received or held in connection with *MiFID business*, it is client money for the purposes of the rules, notwithstanding the agreement between the relevant parties, and should be treated as such by the firm holding the money.

An authorised firm must not treat money belonging to an affiliated company as client money unless the firm is dealt with as a client at arm's length, the affiliated company has informed the firm that the money belongs to an underlying client, or the affiliated company is domiciled outside the United Kingdom, or is the manager of an occupational pension scheme and the money is given to the firm in connection with investment business to be carried on by the authorised firm for or on behalf of the clients of the affiliated company, or the firm has otherwise been notified that the money is to be treated as client money (see CASS 7.1.12A R).

In circumstances where money has remained in the client account for a period of at least six years and the firm can demonstrate that it has taken reasonable steps to trace the client to whom that balance is allocated and to return the balance , an authorised firm may cease to treat that money as client money (see CASS 7.2.19R and 7.2.20E). Where a firm ceases to treat money as client money in these circumstances, it must undertake to make good any valid claim for the released monies (i.e. notwithstanding that the firm may have used the money for its own purposes, it must return an equivalent balance in the event that the rightful owner of that money comes forward).

3.6.3 In what capacity is client money held?

Section 139(1) of FSMA and CASS 7.7.2R impose a statutory trust on money received and held by authorised firms as client money. CASS 7.7.2R provides that an authorised firm receives and holds client money as trustee for the purposes of the rules set out in CASS as to how client money should be held and how it should be distributed on the occurrence of the firm's insolvency. As described above, the Court of Appeal has confirmed that it is not necessary for the money to be both received *and* held to create the trust; it is sufficient that it is either received *or* held.

As stated by CASS 7.7.1G, the result of the statutory trust is that although legal ownership of client money vests in the authorised firm, its beneficial ownership remains in the client. As a result, authorised firms become subject to a fiduciary duty in respect of the money and hold it as trustee for the purposes of and on the terms of the client money rules. CASS 7.7 is short and as an instrument creating a trust it is, in the Court of Appeal's terms, rudimentary. The terms of the trust provide that the money is held for the purpose of the client money rules and that, in the event of the failure of the firm, the money held as client money is required to be applied first to the payment of costs properly attributable to the distribution of the money to clients for whom it is held, secondly to the payment of all valid claims of clients for whom the money is held in accordance with their respective interests in it and finally, to the extent that there is any excess, to the firm itself.

As discussed above, the Court of Appeal has held that where circumstances arise that are not dealt with by CASS 7.7, a court is entitled to apply the principles of trust law to achieve an equitable result. To that effect, the Court of Appeal determined that the phrase "clients for whom the money is held" should be interpreted to mean all clients whose money *should* have been segregated, even if was not actually segregated.

3.6.4 Organisational requirements

A firm that holds client money is subject to the fundamental requirement that it make adequate arrangements "to safeguard the client's rights and prevent the use of client money for its own account" and to "minimise the risk of the loss or diminution of client money … as a result of misuse of client money, fraud, poor administration, inadequate record-keeping or negligence" (see CASS 7.3). Firms should be aware that, as a result of this rule and as with the client asset rules, even where the firm itself has been subject to a fraud (e.g. an employee misappropriating cash), the firm can be subject to disciplinary action where the FSA determines that it did not have in place appropriate systems to detect and prevent that fraud.

Authorised firms may hold client money in a different currency from that in which it is received, but where they choose to do so must daily reconcile the amount held to an amount at least equal to the amount received on the basis of the previous day's spot exchange rate (see CASS 7.4.30R).

3.6.5 Selection of bank to hold client money

When determining where to deposit client money an authorised firm should take into account the need for diversification of risk (see CASS 7.4.9G) and, unless depositing the money with a central bank, must "exercise all due skill, care and diligence" in not only the selection and appointment but also the "periodic review" of the institution or fund with which the money is deposited or invested (see CASS 7.4.7R).

Such due diligence must take into account the capital of the bank, the amount of client money placed with the bank as a proportion of its capital and deposits (or in the case of a *qualifying money market fund*, compared to any limit the fund may place on the volume of redemptions in any period), the credit rating of the bank and, where the information is available, the level of risk in the investment and loan activities undertaken by the bank (see CASS 7.4.9G). A firm should retain a record of the basis on which it satisfies itself as to the appropriateness of a selection for at least five years after the firm ceases to hold client money with the relevant institution (see CASS 7.4.10R).

The CASS rules make no distinction for this purpose between banks in the same group as the authorised firm depositing client money and independent banks. Accordingly, there is no restriction on the amount of client money that a firm places on deposit with an affiliated bank, provided that appropriate due diligence is undertaken and the requirement for diversification is taken into account.

On opening a client account with a bank, the authorised firm must provide written notice to the bank requesting the bank to acknowledge in writing that the relevant account is held by the firm as trustee (or, in Scotland, as agent) and that the bank is not entitled to combine the account with any other account or to exercise any right of set-off or counterclaim against any money owed to it by the firm (see CASS 7.8.1R(1)(a)) and to confirm that the account that is used to hold client money is clearly identifiable as separate from any account used to hold assets belonging to the firm (see CASS 7.4.11R and CASS 7.8.1R(1)(b)). In addition to accounts held with banks, this requirement also extends to accounts held by authorised firms with third parties such as intermediate brokers, clearing houses and OTC counterparties through which it undertakes contingent liability transactions for its clients (see CASS 7.8.2R). If such written acknowledgment is not provided within 20 business days, the firm should withdraw all monies standing to the credit of the relevant account and deposit it elsewhere as soon as practicable (see CASS 7.8.1R(2) and 7.8.2R(2)).

Curiously, in its Client Money and Asset Report of January 2010, the FSA suggests that the requirement to obtain a letter acknowledging trust extends to all third parties that hold client money, such as intermediate brokers[21] (and not just to those banks and third parties through which the firm is undertaking contingent liability transactions for its clients). The CASS rules do not support this assertion, however, given this informal (and non-binding) guidance from the FSA, the cautious approach may be for a firm to seek letters acknowledging trust from all third parties with which it holds client money.

3.6.6 Segregation of client money

On receipt, client money should be promptly paid out in accordance with the rule regarding the discharge of the firm's fiduciary duty to the client (see discussion of CASS 7.2.15R above), or should be segregated by being placed into one or more accounts with a central bank, a bank regulated in the European Economic Area or elsewhere, or a "*qualifying money market fund*" (see CASS 7.4.1R).

The client money rules recognise that the circumstances in which some authorised firms receive client money may be more complex than others. For most firms, the client money rules require that money is paid out or deposited no later than the next business day after receipt. This is known as the "normal approach" (see CASS 7.4.17G). Firms operating the normal approach should take reasonable steps to ensure that client money is received directly into the client bank account, or where such money is received into its own account, to be promptly transferred to the client bank account. In any event, the transfer should take place no later that the next business day after receipt (see CASS 7.4.22G). Where a remittance constitutes part client money and part other money, it should, in the first instance, be paid to the client bank account and then any money that is not client money should be promptly withdrawn and dealt with appropriately (i.e. paid to the firm's own account) (see CASS 7.4.23G).

However, where a firm's auditor has confirmed to the FSA that it has in place systems and controls which are adequate to operate another approach effectively (see CASS 7.4.15R), the firm may, on a daily basis, pay into or withdraw from the client account on a daily basis an amount equal to the net balance of client money received into and paid out from its own bank account. This is known as the "alternative approach" (see CASS 7.4.16G) and was, as discussed below, the method adopted by LBIE prior to its insolvency.

Whether an authorised firm adopts the normal or alternative approach, it is required to undertake reconciliations of the client money that it holds in accordance with the detailed requirements set out in CASS 7, Annex 1.

A firm that adopts the normal approach should check, on a daily basis, whether the aggregate balance on its client bank accounts (its "*client money resource*") was, at the close of the previous business day, at least equal to the total amount of client money held for or owed to each of its clients (its "*client money requirement*") as at the close of business on that day.

By contrast, a firm that adopts the alternative approach is required to check, on a daily basis, that its client money resource is at least equal to the client money requirement on the *previous* business day.

3.6.7 CASS 7.5: Transfer of client money to a third party

Authorised firms may allow a third party, such as an exchange, intermediate broker or clearing house, to hold or control client money, but only if the firm transfers the client money for the purpose of a transaction for a client through or with that person or to meet a client's obligation to provide collateral or margin for a transaction (see CASS 7.5.2R).

Where an authorised firm does allow a third party to hold or control client money, it is required to notify retail clients that their client money may be transferred to a third party (see CASS 7.5.2R). Although there is no requirement to do so, a firm would be well advised, for the purpose of demonstrating a commitment to the FSA's Principles for Businesses and, in particular, the requirement of Principle 6 to treat all customers fairly, to ensure also that any professional client has been made aware that its money may be treated this way (e.g. by including an appropriate provision in the applicable terms and conditions).

Firms should be aware that they remain responsible for any client money held with a third party and, in order to minimise credit risk (for both their own benefit and the benefit of the client), should ensure that any excess client money (i.e. that which is no longer required for the purpose of a transaction or collateral) is returned to the client bank account.

3.6.8 CASS 7A: Client money distribution

CASS 7A describes how client money should be distributed in the event that the authorised firm holding that money fails. The stated intention of these rules is to "facilitate the timely return of client money to a client in the event of the failure of a firm or third party at which the firm holds client money" (see CASS 7A.1.2G). CASS 7A describes two situations in which client money should be distributed: (i) a "primary pooling event" and (ii) a "secondary pooling event".

A primary pooling event occurs when the authorised firm is subject to an insolvency procedure, such as the appointment of an administrator, liquidator or receiver, in the United Kingdom or any other jurisdiction. A primary pooling event will also occur where the FSA imposes a requirement in respect of the client money held by an authorised firm in its Part IV permission or when the authorised firm is unable correctly to identify and allocate in its records all valid claims arising as a result of a secondary pooling event (see CASS 7A.2.2R).

A secondary pooling event occurs where a third party to which the authorised firm has transferred client money becomes subject to an insolvency procedure (see CASS 7A.3.1R).

3.6.9 Primary pooling events

If a primary pooling event occurs, the client money rules require that all monies held in the relevant firm's "client money accounts" be pooled and distributed in accordance with the requirements of the statutory trust provided for at CASS 7.7.2R (i.e. it should be applied, first, to the payment of costs properly attributable to the distribution of the money to clients for whom it is held; secondly, to the payment of all valid claims of clients for whom the money is held in accordance with their respective interests in it; and finally, to the extent that there is any excess to the firm itself). As discussed above, the Court of Appeal has determined that the phrase "client money account", which is not defined in the FSA's rules, is not limited to accounts in which the failed firm has deposited segregated client money. Instead, it is necessary to pool all identifiable client money wherever it is found. Similarly, the phrase "clients for whom the money is held" is not limited to those who have, because their money was segregated by the failed firm, contributed to the pool. Instead, any client whose money *should* have been segregated is entitled to participate in the distribution of pooled money.

Persons who hold client money at authorised firms should be aware of the implications of this rule. It should not be presumed that, because money is, or should be, treated as client money, the client will automatically be entitled to the full return of his money on the insolvency of the firm. Instead, he will be entitled only to a pro rata share of the total pool of identified client money calculated by reference to the proportionate size of his client money claim.

As discussed above, the guidance at CASS 7A.2G that:

> "a client's main claim is for the return of client money held in a client bank account. A client may be able to claim for any shortfall against money held in a firm's own account. For that claim, the client will be an unsecured creditor of the firm"

is dismissed by the Court of Appeal as inaccurate or incomplete. Read in the light of that judgment, it can be seen that it is correct that a client's main claim will be for the return of money held in the failed firm's nominated client bank accounts. However, this is not the only claim that clients will have; they will also have claims against any other identifiable client money wherever it was held by the firm at the date of its failure. To the extent that there is still a shortfall after that, the client will have an additional claim against money held in the firm's own accounts and, in respect of that claim, will be an unsecured creditor.

For the purpose of calculating the client's claim on the client money pool, CASS 7A.2.5R requires the set off of the "individual client balance" and the "client's equity balance". The method for calculating each of these is set out at CASS 7, Annex 1.

In summary, the "individual client balance" is the total amount of client money held for the client, including the proceeds of securities sales and cash used by the client to pay for a purchase of a security but where the security has not yet been delivered to the client.

Also in summary, the client's equity balance is defined as the value of the client's margined (or cash collateralised) transactions with the firm. That is, if, when each margined transaction is closed out, the client owes the failed firm an amount of money, the client's client money claim must be reduced by that amount. If, of course, the result of the equity balance calculation is that the firm owes the client a money amount, that client's client money claim is increased.

Client money received by the authorised firm after the primary pooling event is required to be held in a new client money account and must be returned to the relevant client without delay. Client money received by the authorised firm after the primary pooling event is not permitted to be pooled with the client money held by the authorised firm prior to its failure (see SUP 7A.2.4R).

3.6.10 Secondary pooling events

When a bank with which the authorised firm held a client money account fails and the authorised firm decides not to make good the shortfall in the amount of money held at that failed bank (or is unable to do so), the FSA expects an authorised firm to reflect the shortfall that arises in its records of the entitlement of clients and of money held with third parties. It is normally the case that the FSA expects all holding of client money to share equally in the common misfortune of the failed bank. However, CASS 7A.3 also seeks to ensure that clients who have notified to the authorised firm that they are not prepared to accept the risk of the bank that has subsequently failed and who requested that their client money be held at a different account, should not suffer the loss of the bank that has failed (i.e. if the authorised firm failed, at the request of the client, to transfer the client money away from the failed bank in advance of the failure, the authorised firm itself will be required to make up the shortfall). The importance, therefore, of being meticulous in executing and keeping records of such requests should go without saying.

4 Recent client money enforcement actions

In the spring of 2010, the FSA issued two final notices of enforcement action which related to failures of authorised firms to comply with the client money rules. JP Morgan Securities Limited was fined £33.32 million in respect of its breaches of Principle 10 ("A firm must arrange adequate protection for clients' assets when it is responsible for them") and the CASS 7.4.11R requirement to segregate client money. Rowan Dartington & Co Limited was fined £511,000 in respect of its breaches of Principle 10 and Principle 2 ("A firm must conduct its business with due skill, care and diligence") and various specific requirements of the client money rules. In each case the fines were calculated to represent approximately 1 per cent of the average amount of client money held by the firm. The FSA intended that this level of fine should "send a clear message to the industry of the need to ensure that client money is properly segregated in accordance with the relevant rules and that failure to do so will result in severe consequences".[22]

It should be noted that in the following discussion of these FSA enforcement actions, all statements of fact are based on the relevant FSA final notice and are not based on information obtained from any other source.

4.1 JP Morgan Securities Ltd

On May 25, 2010, the FSA imposed a financial penalty of £33.32 million on JP Morgan Securities Limited ("JPMSL") because, according to the final notice issued by the FSA (the "JPMSL Final Notice"), JPMSL failed to place client money in a segregated trust account and, furthermore, this failure continued for a period of seven years.

It appears that following changes to treasury processes in 2002, which were implemented as part of the post-merger integration of JP Morgan & Co and The Chase Manhattan Corp, JPMSL's treasury function did not distinguish between money belonging to JPMSL's futures and options business ("JPMSL F&O") and money belonging to its clients. As a result, when money held by JPMSL F&O was swept at the end of each business day to an account with JP Morgan Chase Bank, client money was held in the same account as the firm's money.

This error, repeated daily, was not identified for a period of nearly seven years and only came to light during a conversation between senior JPMSL compliance and staff of JPMSL's corporate treasury team. During that conversation it was realised that JPMSL's corporate treasury had not realised that most of the money held by JPMSL F&O was client money and that the JPMSL F&O compliance team had not checked that the money was being appropriately segregated. One can imagine that this must have been a fairly unpleasant moment for the individuals concerned. The subsequent investigation identified that JPMSL had failed to understand the effect of the changes to the treasury processes, failed to carry out a post-implementation review of the changes, which may have identified the error, and did not implement any overarching control processes to confirm that all client money was held in a properly segregated bank account with trust status.

Nevertheless, it appears that once the issue was recognised JPMSL behaved in an exemplary manner. Within 48 hours of the conversation in which the error was finally identified, an internal investigation had confirmed that the client money had not been segregated in the past, procedures were put in place to ensure that it was segregated in the future, an accountancy firm was engaged to conduct a review of the breach and to discover its root cause and the FSA had been notified of the breach. JPMSL also cooperated with the FSA during its subsequent investigation and settled the matter at the earliest stage.

The FSA acknowledged that, following the identification of the error JPMSL, had behaved in an appropriate, constructive and cooperative manner. Furthermore, the breaches were not deliberate and JPMSL did not benefit from them. The FSA also acknowledged that, although it was not an acceptable alternative to segregating client money, JPMSL's customers benefited from a parental guarantee from JP Morgan Chase Bank which may have mitigated any losses they had suffered in the event of JPMSL's insolvency.

However, it is apparent from the JPMSL Final Notice that this was a clear cut breach of both Principle 10 and the client money rules in that JPMSL failed to segregate and therefore to arrange adequate protection of client money held by it with JP Morgan Chase Bank. This breach was exacerbated by both the length in time it remained undiscovered, the failure to put in place systems to confirm that client money was being treated appropriately and the amount of money at stake (at one point in October 2008, $23 billion). Although no client actually suffered a loss, the FSA therefore considered it appropriate to level a fine equal to 1 per cent of the average amount of client money held by JPMSL during the duration of the breach.

4.2 Rowan Dartington & Co Ltd

On June 4, 2010, the FSA imposed a financial penalty of £511,000 on Rowan Dartington & Co Ltd, which principally operates as an equities stockbroker but which also provides services in respect of certain margined products including contracts for difference, because, according to the final notice issued by the FSA (the "Rowan Dartington Final Notice"), Rowan Dartington failed to take reasonable care to make and retain adequate records in relation to its settlement accounts, failed properly to reconcile client money balances internally and adequately to perform reconciliations of internal client money balances against external records, failed to have in place adequate procedures to segregate client money balances in relation to its margined products business and failed to secure an acknowledgment of trust from all of its client account providers and from intermediary brokers holding client money in relation to its contingent liability business. According to the FSA, the overall result of these breaches was that Rowan Dartington was unable readily to demonstrate the recoverability of up to £1.4 million of its net assets.

The FSA found that Rowan Dartington had breached Principle 10 ("A firm must arrange adequate protection for clients' assets when it is responsible for them"), because its underlying accounting records contained inaccuracies, it had failed to obtain trust status letters from relevant third parties and had failed to perform segregation calculations accurately.[23] The FSA also found that Rowan Dartington had breached Principle 2 ("A firm must conduct its business with due skill, care and diligence") because it did not exercise due skill, care and diligence to test new accounting software, it failed to ensure that its training, working practices and other systems complemented its automated accounting and information systems and failed to ensure that balances in its trade settlement and reporting system were properly reconciled with the balances in its financial accounts.

In addition to these breaches of the FSA's Principles for Businesses, the FSA also identified numerous breaches of specific client money requirements. Most of these specific breaches related to the failure to perform proper reconciliations and to maintain adequate records. However, the FSA also noted that Rowan Dartington had failed to obtain letters acknowledging trust from banks with which it had a client money account and, in the case of its margined business, intermediate brokers with whom it placed client money as required by CASS 7.8.1R and 7.8.2R.

In determining the level of penalty, the FSA took into account the fact that Rowan Dartington notified it of the issues that it was having with its accounting software and the potential breaches of the CASS rules promptly after it became aware of them, that the breaches were not deliberate and did not benefit Rowan Dartington, that Rowan Dartington kept the FSA informed of the efforts it was making to rectify the issues that it had identified and that only a small amount of client money was lost and that this was promptly reimbursed. However, the FSA regarded the breaches as particularly serious because they exposed Rowan Dartington's clients to a risk of financial loss and were long in duration. The FSA therefore considered it appropriate to level a fine equal to 1 per cent of the average amount of client money held by Rowan Dartington during the duration of the breach.

4.3 Lessons to be taken

Authorised firms subject to the client money rules should take these enforcement actions as a reminder of the need not only to comply with the client custody and asset rules, but also to ensure that appropriate systems and controls are in place to ensure that client money procedures are being followed and to confirm on a periodic basis that those procedures are working effectively. In particular, authorised firms must ensure that their accounting systems are capable of accurately recording and reconciling client money balances.

To the extent that there was any doubt, it is also clear that the FSA does not consider a parental guarantee of JPMSL's client money obligations to be an acceptable alternative to effective segregation. Indeed, given that the collapse of LBIE has demonstrated that where a significant trading subsidiary collapses it is not impossible for the parent guaranteeing that subsidiary's obligations also to collapse, no matter the quality of its credit rating, it is somewhat surprising that the FSA accepted (to however small a degree) such a guarantee as a mitigating factor in the JPMSL enforcement action.

It is clear that the FSA, in its own words, views compliance "with its client money requirements as of significant importance"[24] and that firms which fail to comply will be subject to a financial penalty even where the breach is not deliberate and does not benefit the firm. The standard tariff has been set at 1 per cent of the average amount of client money held by the firm during the continuance of the breach, to the extent that the FSA identifies and any intentional breach of the CASS rules, or an inadvertent breach leading to significant loss of client money it is likely that the penalty tariff will be significantly higher.

5 Enhancing the client assets sourcebook

In March 2010, the FSA published its Consultation Paper 10/9 "Enhancing the Client Assets Sourcebook" (the "CASS CP"). The FSA notes, with a hint of understatement, that during the course of the financial crisis it had "observed a number of areas in which the CASS regime can be strengthened".[25] The FSA's proposals for strengthening the client asset and money regimes are summarised below.

5.1 Introducing a disclosure annex for prime brokerage agreements

The CASS CP proposes that prime brokers should be required to include in an annex to each prime brokerage agreement entered into a summary of the agreement's re-hypothecation provisions. It appears that the FSA hopes that the annex will highlight to the counterparty (typically an authorised investment manager) the circumstances in which the prime broker can use the assets or money transferred to it for its own purposes and in which those assets therefore cease to be client assets or money. The annex would identify the relevant definitions in the agreement, including net client indebtedness and the contractual limit on re-hypothecation and would include a statement setting out the risk to the client's assets upon the prime broker's default. The FSA intends that this summary would help to address the lack of understanding, highlighted by the collapse of LBIE, amongst sophisticated market participants of how their money and assets would be treated on the insolvency of the prime broker.

The FSA also expresses the hope that this annex would reduce the amount of time spent by an insolvency practitioner and its advisers conducting due diligence following such an insolvency. The FSA says that the annex would not affect the terms of the contract.

In an age when the hedge fund manager appears to be the bogeyman of the regulators, it seems odd that they are to be afforded this "protection" and it is not at all clear as to how much benefit it will offer. Although it is true, as noted above, that there does appear to have been prior to the collapse of Lehman a certain lack of understanding amongst asset managers as to the impact of re-hypothecation provisions in prime brokerage agreements, the industry has learned its lessons and asset managers are now far more likely to seek specialist advice on such agreements and, furthermore, will now typically insist on additional measures to limit loss in the event of a prime broker's insolvency.

Notwithstanding that the FSA states that the annex will not be contractually binding, it is inevitable that the annex will be used, in the event of a dispute, as evidence of the parties' intentions and as a tool for interpreting the provisions of the contract itself. As such, there is as much, if not more, potential for confusion as there is for clarification. The FSA's suggestion that the annex will reduce time spent on due diligence following an insolvency is, frankly, fanciful. Instead, contractual provisions will need to be checked against the annex to ensure that it accurately reflects the provisions of the underlying contract.

In the event that this proposal is enacted, clients of prime brokers would be well advised to be cautious that the mandated re-papering exercised is not used as an excuse to standardise bespoke agreements which have previously been negotiated.

5.2 Reporting to prime brokerage clients

Prime brokers are currently required by the FSA's Conduct of Business sourcebook to provide annual reporting to their clients. In reality of course, most clients now insist on far more regular reports: most prime brokers now offer daily reporting and a move toward real-time transparency is gathering momentum. This increased transparency is, in part, a product of competition between prime brokers and improved information technology. But it is also, of course, a reaction to the collapse of Lehman where the administrators were hampered by a lack of recent information about client accounts and in particular a lack of clarity as to whether pre-insolvency instructions had been executed, which assets had been segregated and which assets had been re-hypothecated. The FSA intends to address these problems with a new requirement for prime brokers to provide at least daily reporting. The FSA considers that it would be dangerous to rely on the evolving market practice for increased transparency for fear of a sense of complacency setting in as the market recovers and lessons from Lehman are forgotten. There is probably truth in this and, provided that it is clear that daily reporting is a minimum standard and does not impede the move toward real-time transparency, this proposal should be welcomed by the asset management community.

5.3 Restricting the placement of client money deposits held with group entities

LBIE placed a significant proportion of its client money on deposit with its German affiliate Lehman Brothers Bankhaus AG ("Bankhaus"). Bankhaus collapsed at the same time as the rest of the Lehman group, and its depositors, including LBIE in respect of client money that it held, became unsecured creditors. As discussed above, the client money rules do not limit the amount of client money that is held with a bank in the same group as the authorised firm depositing client money subject to the requirement for diversification and due diligence.

As the CASS CP notes, all client money will eventually be held as a deposit and therefore subject to loss in the event of a bank's insolvency. The CASS rules take account of this and provide that clients will be entitled to a pro rata share of the client money pool once it is determined (and, therefore, a pro rata share of any loss). However, the FSA is concerned to address the risk, which materialised with LBIE, that an authorised firm will "place an inappropriate amount of client money intra-group, usually as a source of liquidity" creating additional or concentrated risks for the underlying client. The FSA therefore intends to limit the amount of client money that may be deposited in intra-group bank accounts to 20 per cent. This appears to be a sensible proposal, which will go some way to reducing the impact of a large-scale insolvency such as that of LBIE. However, authorised firms that do currently place large amounts of client money on deposit intra-group should be aware of the likely effect of the proposal on group liquidity.

5.4 Prohibiting the use of general liens in custodian agreements

As discussed above, in CASS 6.3.3G the FSA indicates that third parties entrusted with client assets (i.e. custodians) should be restricted from exercising any lien, right of retention or right of sale over the safe custody assets. The FSA intends to convert this non-binding guidance into a rule which will prohibit authorised firms from allowing general liens over client assets. It would not be permitted to exercise a lien over client assets in respect of debts owed by the authorised firm to the custodian (except to the extent necessary to cover unpaid fees). This again appears to be a sensible proposal.

5.5 Creation of a new controlled function

The FSA observes in the CASS CP that responsibility for client money and assets is often split among a number of staff across compliance, operations, finance and corporate treasury functions, leading to a lack of effective oversight. Although not referred to in the CASS CP, it appears likely that this type of splintered responsibility was at least in some part to blame for the error that led to the enforcement action against JPMSL discussed above. The FSA has therefore proposed that one person at each firm be required to have ultimate oversight responsibility for client assets and money. The proposed function, to be known as the "CASS Oversight controlled function", will include general oversight of the firm's compliance with CASS reporting to the firm's governing body and completing and submitting the client money and asset return. Where the firm holds a significant amount of client money or assets (in excess of £1 billion client money or £100 billion of client assets), the FSA will assess the competency of the relevant individual before approving him or her to perform the CASS Oversight controlled function.

5.6 Client money and assets return

The FSA also indicates its intention to require authorised firms with permission to hold client money or assets, to submit on a monthly or bi-annual basis, depending on the amount of money and assets held, to the FSA a client money and asset return in which firms will report the level of money or assets they hold, where they hold it and the top five banks used for depositing client money. It is hoped that this will allow the FSA an overview of firm-specific holdings and an understanding of the level of UK investment firms' holdings of client assets and money with the intention of making micro or macro regulatory interventions, as necessary.

This requirement will clearly add an administrative burden to firms which hold client assets and money. However, it can be seen that the information may be of benefit to the FSA if it can be effectively marshalled.

5.7 Next steps

The FSA requested that comments on these proposals be submitted to it by the end of June 2010, with a view to issuing a policy statement in Q3 2010 and implementing rules in early 2011. That policy statement remains imminent. Notwithstanding that the proposals made by the FSA in the CP CASS are, broadly, sensible (although it is difficult to see that any perceived advantages of the disclosure annex for prime brokerage agreements are not outweighed by the costs and potential for confusion), the proposals do not address the deficiencies in drafting identified by the Court of Appeal.

6 Conclusion

It is clear from the Client Money and Assets Report and the CASS CP that the FSA has recognised the harm that has been done to confidence in its client assets and money regime during the course of the financial crisis. The FSA has, in these papers and in the enforcement actions it has taken, demonstrated an understanding of the importance of ensuring that the existing client asset and money regime is effectively implemented by authorised firms so as to rebuild confidence. The proposals the FSA has made for enhancing that regime in the CASS CP are, on the whole, helpful and to be welcomed.

Nevertheless, there are at present no signs that the FSA has sought to address the serious deficiencies in the drafting of the CASS Rules identified by the Court of Appeal. It was, of course, unhelpful to LBIE's administrators (and indeed creditors) that recourse to the courts was necessary in order to clarify the meaning of the client money rules. Although, the "black holes" identified by the Court of Appeal were perhaps understandable in a set of rules that had not previously been tested by such a significant insolvency, it is nevertheless undesirable that a set of rules which are intended to be self-contained and easily understood by the regulated community cannot be fully explained without reference to a court's decision. For the sake of both certainty and confidence in the rules, a serious review of the client asset and money rules should be undertaken with a view to addressing the Court of Appeal's concerns and ensuring that the rules present a "coherent scheme".

Notes

1 FSMA, ss.2(a) and 3.

2 [2010] EWCA Civ 917.

3 See [58] of the Court of Appeal judgment.

4 Directive 2004/39/EC.

5 See [58] of the Court of Appeal judgment.

6 See [66] and [67] of the Court of Appeal judgment.

7 See [104] of the Court of Appeal judgment.

8 See [88] of the Court of Appeal judgment.

9 See [139] of the Court of Appeal judgment.

10 See [124] of the Court of Appeal judgment.

11 See [125] of the Court of Appeal judgment.

12 See [129] of the Court of Appeal judgment.

13 See [154] of the Court of Appeal judgment.

14 The FSA reorganised the CASS handbook on January 1, 2009, shortly after the administration of LBIE. Prior to 2009, these rules were found in CASS 7.9, but are now located in CASS 7A. However, the substance of the wording under consideration by the Court of Appeal remains the same.

15 The investment services and activities listed in s.A of Annex I to MiFID are: reception and transmission of orders in relation to one or more financial instruments; execution of orders on behalf of clients; dealing on own account; portfolio management; investment advice; underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis; and operation of multilateral trading facilities.

16 The financial instruments listed in s.C of Annex I to MiFID are: transferable securities; money-market instruments; units in collective investment undertakings; options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivative instruments, financial indices or financial measures which may be settled physically or in cash; options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (other than by reason of a default or other termination event); options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or a multilateral trading facility; options, futures, swaps, forwards and any other derivative contracts relating to commodities that can be physically settled not otherwise mentioned in (f) and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls; derivative instruments for the transfer of credit risk; financial contracts for differences; and options, futures, swaps, forward rate agreements and any other derivative contracts (provided that the contract may be settled in cash or provided that it is traded on a market or trading facility) relating to climatic variables; freight rates; emission allowances; inflation rates or other official economic statistics; telecommunications bandwidth; commodity storage capacity; transmission or transportation capacity relating to commodities, whether cable, pipeline or other means; an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources; a geological, environmental or other physical variable; any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred; an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation.

17 See also CASS 1.2.3R.

18 See CASS 1.2.8G.

19 See FSMA, s.39(4) and CASS 1.4.5G.

20 See [172] of the Court of Appeal judgment.

21 See para.2.1.7 of the FSA's *Client Asset & Money Report* January 2010.

22 See para.5.17 of Final Notice in respect of JP Morgan Securities Limited.

23 See para.2.2 of the Rowan Dartington Final Notice.

24 See para.5.4 of the JPMSL Final Notice.

25 See para.1.3 of CP 10/9.

26 See para.3.8 of CP 10/9.

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Author: Brian McDonnell, Olswang LLP

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