

2010

Ask the Professor: How Does the U.K. Client Money Rules Differ from the U.S. Customer Segregated Rules when the Custodian Firm Fails to Treat Customer Property Properly?

Ronald Filler

New York Law School, ronald.filler@nyls.edu

Follow this and additional works at: https://digitalcommons.nyls.edu/fac_articles_chapters

 Part of the [Banking and Finance Law Commons](#), and the [Bankruptcy Law Commons](#)

Recommended Citation

30 Futures & Derivatives Law Report 8-11 (December 2010)

This Article is brought to you for free and open access by the Faculty Scholarship at DigitalCommons@NYLS. It has been accepted for inclusion in Articles & Chapters by an authorized administrator of DigitalCommons@NYLS.

1 Tatsu Katayama is a partner at Anderson Mori & Tomotsune and specializes in the areas of international banking, finance and securities matters with particular emphasis on structured finance, financial derivatives and other complex financial transactions.

2 Ayako Kuyama is an associate at Anderson Mori & Tomotsune, primarily working in the field of financial regulatory issues and derivatives. She regularly advises on the establishment and licensing procedures of companies engaging in derivatives business.

3 Such subordinate regulations are (i) a Cabinet Order, promulgated in September 2010, and (ii) an Enforcement Regulation, promulgated in October 2010.

4 The underlying assets of the transactions that the Commodity Exchange Act regulates are "commodities". "Commodities" are defined as including certain tangible assets such as agricultural, forestry, animal, and aquatic products, and metals and mineral substances. Accordingly, derivatives transactions based on intangible assets such as electric power, emissions allowances and freight rates are outside the scope of the Commodity Exchange Act and will be outside of the scope of the Amended Act as well.

5 In addition to the general regulations above, certain institutions licensed or authorized to operate banking, securities or insurance businesses are, pursuant to the regulations governing them, (i) required to submit notifications to, or obtain the approval of, the relevant Japanese authorities when they begin to operate (in addition to their licensed or authorized business) a commodity derivatives business, and/or (ii) restricted from engaging in certain types of commodity derivatives business. Such institutions will continue to be subject to these regulations under the Amended Act.

6 An entity intending to engage in an only intermediary business relating to commodity derivatives transactions will be permitted to do so without obtaining regulatory approval as a "commodity derivatives dealer"; however, such entity must register as a "commodity derivatives intermediary" and specify the commodity derivatives dealer(s) for which it will be acting.

7 An entity may, without obtaining an approval as a commodity derivatives dealer, perform its obligations under an OTC commodity derivatives transaction or a commodity derivatives transaction traded on an offshore exchange, as long as the entity enters into the transaction before the Amended Act fully takes effect (i.e., January 1, 2011).

8 Such entities are limited to certain types of financial institutions incorporated or licensed under Japanese law.

9 Such approval must be renewed every six years.
10 Such registration must be renewed every six years.

11 However, very high net worth individuals may be exempt from such restriction.

Ask the Professor: How Does the U.K. Client Money Rules Differ From the U.S. Customer Segregated Rules When the Custodian Firm Fails to Treat Customer Property Properly?

BY RONALD H. FILLER¹

Introduction

Section 4d of the Commodity Exchange Act² and CFTC regulation 1.20³ requires a futures commission merchant ("FCM") to maintain and hold customer property deposited in a futures account in a customer segregated account. The FCM, in essence, acts as a trustee over such customer property and must maintain such customer property in accordance with applicable laws and regulations. Similarly, in the U.K., pursuant to the FSA Client Asset Sourcebook ("CASS"),⁴ client property, referred to there as "client money" must also be segregated and be subject to a similar trust law concept. The purpose of both approaches is to establish procedures such that customer prop-

erty IS protected, via these customer segregated or client money accounts, from the claims of third party creditors in the event the customer's financial institution files for bankruptcy.

On September 15, 2008, Lehman Brothers Holdings Inc., the parent company of all Lehman Brothers entities and the NYSE public company, filed for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York. On that same day, Lehman Brothers International (Europe) ("LBIE"), its principal U.K. entity and the entity registered with the FSA, files for bankruptcy under the U.K. Insolvency Act of 1986. In the U.S., Lehman Brothers Inc. ("LBI"), which was registered as a broker-dealer with the SEC and as a FCM with the CFTC, did not file for bankruptcy that day. In fact, LBI continued to operate throughout that week of September 15 – 19, 2008, which gave its customers the opportunity to transfer their open positions and collateral to other firms or to liquidate their open positions during that entire week. By continuing to operate for these five additional days, LBI, as an FCM, did not incur any significant customer property issues as a consequence of its parent and affiliates' bankruptcies.⁵ LBI's customers were always 'whole' with respect to their futures positions and other assets held in customer segregation.

However, events were dramatically different at LBIE which, as noted above, filed for U.K. bankruptcy on September 15, 2008. On that day, Price Waterhouse Coopers was appointed as Administrator over the LBIE estate, a role similar to that of a Trustee in U.S. bankruptcy proceedings.

Recently, on August 2, 2010, the U.K. Court of Appeals issued an important opinion involving U.K. client money rules which overturned a lower court decision and other U.K. precedents.⁶ This article will analyze that decision and its impact on the U.K. financial community.

Background

As noted above, U.K. firms are required to maintain client property in a "client money" account. The issue is what protections, if any, do customers receive in the event their firm does not

properly hold their property in compliance with CASS7. In the *Global Trader* case, which arose in the same time frame as the Lehman bankruptcies, the U.K. High Court held that customers are completely at risk if their financial firm, Global Trader in this case, failed to comply with the CASS7 rules and would thus become unsecured creditors of the bankrupt estate.⁷ If, appeared to be the case, LBIE did not hold all of its customer property in accordance with CASS7 rules, the affected customers would be reduced to unsecured claims. Conversely, LBIE customers, with funds held in accordance with CASS7 rules, would be made whole and would not have their assets haircut by the claims of other customers whose funds were held, without their knowledge, outside the CASS7 rules. In other words, the question before the U.K. courts was whether to give preferential treatment to those customers whose assets were held in compliance with the CASS7 rules or to treat all LBIE customers, including those whose assets were not held in a client money account, equally under trust law, effectively 'saving' the latter customers at the cost of the former.

Incidentally, it is worth keeping in mind that we just passed the two year anniversary of the Lehman Brothers' bankruptcy filing, and the future distribution of U.K. customer funds, under any scheme, is still not known. The funds remain frozen.

The U.K. Decisions

In two judgments handed down on December 15, 2009 and on January 10, 2010, Briggs J held that LBIE customers with client property not segregated in accordance with CASS7 at the time of administration (e.g., on September 15, 2008), had no claim against the client money pool ("CMP") of properly segregated funds and thus would be treated as unsecured creditors. These decisions were appealed.

On August 2, 2010, the U.K. Court of Appeals reversed the High Court decisions and held that client money property should be treated equitably, whether the client monies were held in accordance with CASS7 or not. As of this writing, the

Administrator has sought permission of the U.K. Supreme Court to appeal the Court of Appeal's decision.

The U.K. Court of Appeals, in essence, held as follows:

1. The statutory trust over client money takes effect immediately upon receipt of the client monies.
2. CASS7 requires client money pooling (CMP) of all identifiable customer property wherever it may be found, and not just the amount of client money actually held in the segregated accounts.
3. All clients have a contractual right to participate in distributions from the CMP, not just those whose property happened to be properly segregated.

Issues Raised by this Decision

In determining that all identifiable clients are entitled to a distribution from the CMP, including clients of Lehman affiliates whose assets were not held in a segregated account, the U.K. Court of Appeals appears to focus on the method used by a financial firm, such as LBIE, to place client property in the CMP. Thus, if a firm accepts the client assets initially in a firm account and then transfers the client property to the CMP, those clients whose funds had not been transferred to the CMP as of September 12, 2008, should be treated as if their funds were transferred to the CMP. In the U.S., pursuant to Section 4d of the CEA and CFTC Rule 1.20, customer property at all times must be held in a customer segregated account. The U.S. FCM is not permitted to allow a customer to send its property to a bank account in the name of the FCM but must send the wire transfer funds directly into the customer segregated account at the respective custodian bank. When such funds are then transferred to the clearing house to margin the underlying open futures contracts, the customer funds are transferred from the FCM's customer segregated account to another customer segregated account held by the clearing house on behalf of its clearing member

firm, the FCM in this case. Funds are returned back the same way.

In contrast to the U.S. rule, the U.K. Court of Appeals appears to have approved the receipt of funds outside the client money account (i.e., a direct deposit in the house account) and treated these funds as if these funds were held in the CMP. Under prior precedents, only those client funds held in the CMP received the statutory protection. The U.K. Court of Appeals has thus decided to protect those customers whose client property was not placed, for whatever reason, in the CMP, thus supporting the argument that customers of a U.K. firm, who have no control over or knowledge as to how the financial firm handles their funds, should be protected.

In its opinion, the U.K. Court of Appeals also established two rights. One is a contractual right, that is, all client monies held in the CMP have a contractual right to distributions from the CMP. However, it goes further and seems to be establishing a property right, that is, that all client monies have a right to the property in the CMP even if their respective assets, through no fault of their own, were not placed in the segregated account.

Finally, this decision places a significant burden on the Administrator. The Administrator must now determine which customer property that was not held in the segregated account should be identified as belonging to the trust assets for distribution. This is not an easy task.

Conclusion

Time will tell whether the U.K. Court of Appeals decision will be the final outcome or not or whether the High Court decisions in *Global Trader* and *LBIE* will be reinstated. Going forward, however, another solution is to simply require by regulatory fiat that all client assets be held 100% of the time in the CMP.

NOTES

- 1 Ronald Filler is a Professor of Law and the Director of the Center on Financial Services Law at New York Law School. He is also the Program Director of the LLM in Financial Services Law program at NYLS which offers

more than 40 courses involving various aspects of the global financial services industry. Go to www.nyls.edu/financellm to learn more about this very unique LLM program. Before joining the NYLS faculty in 2008, he was a Managing Director in the Capital Markets Prime Services Division at Lehman Brothers Inc. in its New York headquarters.

© 2010 Ronald H. Filler. Printed with permission.

2 7 U.S.C. §§1 et al.

3 17 C.F.R. §1.20.

4 See Section 139 of the Financial Services and Markets Act of 2000. The UK client money rules are reflected in Chapter 7 of CASS, and are thus commonly referred to as CASS7.

5 See "Are Customer Segregated/Secured

Amount Funds Protected After Lehman?,"

by Ronald Filler (FDLR, November 2008 Issue, Volume 28, Number 10).

6 *Lehman Brothers International (Europe) (In*

Administration) v. CRC Credit Fund Ltd & Ors.,

EWCA Civ 917 (August 2, 2010).

7 *Global Trader Europe Limited (in liquidation)*

(2009), EWHC 602 (CH).

