

Clients & Friends Alert

Supreme Court Gives Protection to All UK Client Money

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On 29 February, the Supreme Court of the United Kingdom handed down its judgment on the treatment of client money that had not been segregated, or was improperly segregated, as at the date [Lehman Brothers International \(Europe\) \("LBIE"\)](#) entered administration. The Supreme Court found that:

- 1 The "statutory trust" over customers' cash arose when LBIE received the money and not on segregation;
- 2 Money does not have to be in a client account to be "client money"; money held in a house account of the insolvent firm may be client money; and
- 3 Clients whose cash had not been segregated on LBIE's entry into administration (but should have been) could share in the client money pool.

Background

The appeal focused on the treatment of "client money"- cash that should have been segregated for LBIE clients in accordance with Chapter 7 of the Client Assets Sourcebook ("**CASS Rules**") of the Financial Services Authority ("**FSA**"). The CASS Rules require authorised investment firms to segregate certain money that they receive from their clients by placing it into a client money account so that it is kept separate from the firm's own money. The CASS Rules protect client money by providing for segregation and the creation of a "statutory trust" over the cash.

Issues on Appeal

The three key questions for the Supreme Court were as follows:

- 1 Whether the "statutory trust" arises (1) when the money has been placed in a segregated client account, or (2) as soon as the firm receives the money, irrespective of where it puts the money;

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- 2 Whether the FSA rules apply to client money held in house accounts; and
- 3 Whether participation in the client money pool available for distribution to claimant customers depends on actual segregation.

Judgment

Lord Dyson, delivering the lead judgment for the majority, adopted a purposive interpretation of the CASS Rules and the relevant provisions in the Markets in Financial Instruments Directive (“MiFID”) from which the CASS Rules are derived. Lord Dyson held that MiFID’s “overriding purpose is to safeguard the assets of all clients and to provide all clients with a high degree of protection”. The Supreme Court’s unanimous decision was that the trust over the client money arises on receipt, rather than on segregation, and the majority decided that the intention of the CASS Rules is to operate to protect and distribute according to those rules all client money, including money held in a house account and money that should have been segregated but was not.

Dissenting Judgments

Lord Hope and Lord Walker dissented on the second and third issues, broadly on the grounds that English law requires both segregation and a declaration of trust in order to afford full protection. Lord Walker, in his dissenting judgment, raised an interesting objection to the “cataclysmic shift of beneficial interest on [a primary pooling event] to the detriment of those clients who must have supposed that their funds were safely segregated”, amounting to “the segregated clients’ funds being used as a strange form of compensation fund for disappointed clients whose funds had not been segregated”.

Consequences

- 1 *For the LBIE administration.* The administrators will have to undertake a potentially lengthy exercise to trace client money in house accounts. Even though such exercise may be well on its way, further delays in distributions to creditors will ensue. The number of clients having a claim against the client money pool will increase; although at the same time the size of the client money pool should increase too with some of the cash held in house accounts being identified as “client money” and transferred to the client money pool. It is also expected that PWC will have to seek court directions relating to the procedure for identifying client money.
- 2 *For the MF Global special administration.* Customers and affiliates whose cash should have been segregated, but was not are likely to be in a better position to argue that they are entitled to share in the client money pool. The cumulative result will be a smaller pot of cash available to those creditors whose assets were properly segregated when MF Global went into Special Administration. KPMG, MF Global UK’s Special Administrator, is also likely to seek further court directions regarding the procedure for

identifying “client money” in the house accounts, so delays in distributions are expected.

- 3 *For FSA authorised firms.* The Supreme Court judgment has confirmed the high level of investor protection that the FSA rules should provide. The regulator has been paying particular attention to the operation of client money protections in recent years, and levying some significant fines for failure to segregate (£33.32 million on J.P. Morgan Securities Ltd in 2010 and £1.12 million on Barclays Capital Securities Ltd in 2011 are just two examples). Given the tremendous difficulties generated in the LBIE administration by failures to segregate cash properly (a “falling short...on a truly spectacular scale” according to Mr. Justice Briggs’ first instance judgment), client money is bound to continue to capture the FSA’s attention.

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