

## **Client money segregation: the global minefield — recent UK developments**

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The demise of Lehman Brothers brought about increased awareness by clients of similar broker firms to segregate client money from that of the broker firm. The advantage would be that the client's money would then generally be protected against the unsecured creditors of the bankrupt broker firm, although with a number of caveats. This year in the UK, there has been significant developments in the segregation of client money held with a firm under the Financial Services Authority's Client Assets sourcebook rules. In most trading scenarios, however, client money segregation cannot be viewed from a UK-only perspective. It has a multi-jurisdictional impact, as client money can be held in other jurisdictions to facilitate trading or to attract higher interest rates on deposits. These jurisdictions may not, however, provide the same level of protection as in the UK. This is the first part of a two-part series which will briefly look at the developments to client money in the UK during 2009. The second part will suggest how to manage the impact of these developments and the questions to ask a broker firm on its client money management in other jurisdictions with lesser client money protection than the UK.

### **Notable UK developments in 2009**

- January 1, 2009 — reforms to CASS rules took effect.
- March 24, 2009 — judgment in *Global Trader Europe Limited* delivered by Sir Andrew Park.
- May 2009 — HM Treasury consultation paper on effective arrangements for investment banks.
- May 2009 — PricewaterhouseCoopers, as administrators to Lehman Brothers International Europe, applied for court directions on questions relating to the CASS rules.
- June 15, 2009 — the Financial Markets and Insolvency Regulations 2009 took effect. The regulations amend part seven of the Companies Act 1989, the Financial Markets and Insolvency Regulations 1991 and the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001.
- Announcement of the FSA's consultation paper on client assets, to be released in the fourth quarter of 2009.

### **The 2009 Insolvency Regulations — more reason to segregate client money**

The 2009 Insolvency Regulations have updated and expanded the rights of recognised investment exchanges and recognised clearing houses to close out, according to their respective rules, the

unsettled market contracts of a defaulting member. These actions are protected against undoing by the liquidator of the defaulting member. Some of the expanded rights of an RIE or RCH now include:

- Member contributions to their respective default funds.
- Some of their cross margining arrangements.
- An expanded definition of market contracts.

The 2009 Insolvency Regulations, however, also introduced an important amendment which will benefit clients under CASS 7 client money segregation, to the detriment of clients who gave title transfer of money to the defaulting member in accordance with CASS 7.2.3R.

Following the close out of a defaulting member's contracts, an RIE or RCH can now use the resulting surplus on that member's house account to make up for a deficit on the same defaulting member's client account held at an RIE or RCH. This will result in less funds becoming available to the liquidator to distribute among the unsecured creditors of the defaulting member.

Clients who gave title transfer of money under CASS 7.2.3R will be deemed as unsecured creditors in respect of that money. To avoid the discriminatory effect of the 2009 Insolvency Regulations, such clients should either opt for client money segregation or be increasingly cautious from a credit and reputation perspective on the choice of member to clear their trades.

### **Global Trader and the Lehman application**

*Global Trader* deals with the interpretation of a number of CASS rules.

Points of concern:

- During the implementation of the Markets in Financial Instruments Directive in 2007, Global Trader took most of its customers unilaterally out of client money segregation by way of an e-mail, which was hyperlinked to the new terms and conditions. Subsequent trading by customers constituted consent to the content of the e-mail and new terms. The court held that these amendments were valid.
- Client money segregation customers lost their protection to credit balances that were realised from the closing out of these customers' open positions after Global Trader went into administration. The court ruled it was deemed as contractual claims for debt and should form part of the unsecured creditors' pool.
- Client money segregation customers, who were contractually entitled to client money segregation, effectively lost their protection because Global Trader failed to put their money in client money accounts.

Soon after the Global Trader decision, the administrators of LBIE applied for court directions on at least 30 CASS-related questions. This court direction is significant at a time when many brokers, post-MiFID and Lehmans, either to comfort their concerned customers or due to a sense of responsibility, put their customers' money in client money segregation. The administrators, however, support the view that client money protection should be effective under such circumstances, provided the money is identifiable.

A substantive directions hearing on the substance of these questions is expected in the fourth quarter of 2009.

### **Reforms to the CASS rules, HM Treasury consultation paper and forthcoming FSA consultation paper on client assets**

The FSA consultation paper on client assets is to be released in the fourth quarter of 2009. Both the HM Treasury paper and the summary of responses to the 2009 Insolvency Regulations consultation paper identified a number of client money issues but deferred addressing these to the upcoming FSA consultation paper. One of the deferred issues that the 2009 Insolvency Regulations consultation paper raised was the extension of client money segregation by an RIE and RCH to a member's client account, which can also consist of money that the segregation rules of other jurisdictions govern.

It is commendable that the global nature of client money segregation, with its added foreign law complexities, is being addressed; however, the City of London Law Society's Financial Law Committee in its response to this question cautioned that the duty to investigate the foreign law requirements should remain with the member and not the RIE or RCH. In view of the various client money issues that have been raised, the FSA consultation paper is eagerly awaited to address these important issues