

Client money segregation: the global minefield — part three

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In his December 15, 2009 judgment delivered on various CASS rules, Mr Justice Briggs described the operation of CASS client money rules in relation to its initial objectives as an "imperfect and hugely complex real world". This judgment together with the Financial Services Authority's recently released consultation paper on enhancing the Client Assets Sourcebook are just two of a number of fascinating developments since September 2009 on CASS client money and asset rules. Part three of the series looks at the latest developments and part four suggests further practical ways of managing the impact of these developments. (See also part one and part two.)

Notable recent developments

- October 21, 2009 — judgment by Mr Justice Briggs on the treatment of cash under the International Prime Brokerage Agreement (Charge Version) of Lehman Brothers International Europe ("Charge IPB Agreement") Citation [2009] EWHC 2545 (Ch).
- December 15, 2009 — judgment delivered by Mr Justice Briggs on the client money application of Lehman Brothers International Europe.
- December 16, 2009 — HM Treasury releases its consultation paper on establishing resolution arrangements for investment banks.
- January 19, 2010 — the FSA releases its "Dear CEO" letter on client money and asset report.
- January 26, 2010 — appeal filed against the judgment delivered by Mr Justice Briggs on December 15, 2009.
- 30 March 2010 – FSA releases its Consultation Paper on Enhancing the Client Assets Sourcebook CP 10/9.

Judgment in the Lehman charge IPB agreement

This case analysed the controversial dual role of a prime broker as a trustee and counterparty under prime broker arrangements. Clause 5.2 in the Charge IPB Agreement, which Mr Justice Briggs referred to as a "linguistic descendant of CASS 7.2.3", stipulates that all cash received under the Charge IPB Agreement will be received by Lehman with full title transfer. Some of the cash received, however, was part of an income stream from securities that Lehman held in custody/trust for some customers under the same Charge IPB

Agreement. The first respondent argued that this cash income was under client money protection and did not form part of the title transfer arrangement. On analysis of the Charge IPB Agreement, it was held that detailed provisions were indicative of a trust intention which, in turn, preserved the proprietary rights of the customers of the custody securities. The court further held that the sweeping language in favour of title transfer did not apply to the cash income of the custody securities which was held to be under client money segregation and did not form part of the unsecured creditor pool. This case is helpful in providing some guidance to both prime brokers and their customers on drafting agreements with the objective of creating a trust/custody and client money segregation.

Judgment in the LIBIE client money application

This 128-page judgment addressed a number of issues around the CASS rules. An appeal, however, has already been lodged against this decision. Whatever the outcome of the appeal, the factual management of client money is still one of the dominant factors in determining if clients' money is in or out of client money protection and the case provides useful insight on such factual management in a global investment bank. Part four will look in more detail at factual management.

The judgment is based on:

- 26 CASS related questions whereby PricewaterhouseCoopers, as administrators to LBIE, asked the court for specific directions.
- Nine respondents and PwC seeking answers on various issues with differing interest around the CASS rules segregation.

The drafting style of the CASS rules specifically came under fire from Mr Justice Briggs to the extent that counsel for the FSA had to acknowledge that some of the rules were plainly wrong from a drafting perspective and that the FSA intended to correct it "as soon as practicable". A discussion on the points under appeal can only be useful once judgment on appeal has been delivered. The FSA has already indicated, however, that further consultation papers are due to follow in July 2010 and the outcome of this appeal may trigger further amendments to the CASS rules.

HM Treasury releases its consultation paper on establishing resolution arrangements for investment banks

This comprehensive consultation paper devotes at least two full chapters to client money and asset protection. Some new proposals made in the HM Treasury consultation paper include the creation of:

- A client assets agency to monitor pre-insolvency best practice in the treatment of client money and assets.
- A client assets trustee to work in conjunction with an administrator/liquidator of an insolvent firm but having a priority task of returning client money and assets post-insolvency.

This paper also supports the:

- Establishment of bankruptcy-remote vehicles for client assets.

- Limitations on the transfer of client money to affiliates in jurisdictions whose laws will weaken CASS rules protections.
- Requirement for firms to divide client money into different pools which will facilitate quicker return of product specific client money.
- Establishment of bar dates for client claims.

FSA releases its consultation paper on enhancing the Client Assets Sourcebook

This much awaited CP10/09 proposes a number of changes on client money/asset protection, including some that the HM Treasury consultation paper proposed. These proposed changes to the CASS rules for firms authorised to keep client money include:

- Where a firm as a prime broker has a dual role as custodian and counterparty, it must disclose its rights of re-hypothecation (title transfer) in a mandatory annex to prime broker agreements.
- A restriction on firms to hold only 20 per cent of client money intra group.
- A requirement of daily reporting by a prime broker firm to reflect the cash value of prime broker related products.
- The guidance in CASS 7.4.9 on choosing where a firm should keep its client money will become mandatory.
- Limiting liens in third-party custodian agreements only to unpaid fees of the custodian and, therefore, prohibiting other general liens on retention or sale of custody assets, which in the past even extended to similar liens in favour of a custodian's affiliates.
- Firms will be categorised as small, medium and large and client asset oversight responsibilities will be allocated to a specific person who has to comply with differing adequacy standards, depending on the categorisation of the firm.
- Monthly and bi-annual reporting to the FSA of client money and client asset positions held at a firm.

The return date for the FSA consultation paper is June 30, 2010, with a policy paper to follow during the third quarter of 2010. The FSA will also follow up in July 2010 with a further quarterly consultation paper on title transfer arrangements and with another consultation paper in September 2010 on the standard of auditing reporting pursuant to the CASS rules. The various consultation papers together with the outcome on the LIBIE litigation will increasingly affect client money and asset protection and a conclusive outcome will hopefully be reached in 2011. Part four in this series will make suggestions to manage some of these developments