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# Ask the Professor: What is the Impact on MF Global From the Recent UK Supreme Court Decision Involving Lehman Brothers International (Europe)?

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# ASK THE PROFESSOR:

## WHAT IS THE IMPACT ON MF GLOBAL FROM THE RECENT UK SUPREME COURT DECISION INVOLVING LEHMAN BROTHERS INTERNATIONAL (EUROPE)?

BY RONALD FILLER<sup>1</sup>

On February 29, 2012, the Supreme Court, the UK's highest court (hereinafter referred to as the "UK Supreme Court"), issued the long-awaited landmark decision regarding how client funds held by Lehman Brothers International (Europe) (hereinafter referred to as "LBIE") will be treated and distributed following the insolvency of LBIE.<sup>2</sup> Arguments were heard over four days on October 31 and November 1, 2 and 3, 2011, before Lords Hope, Walker, Clarke, Dyson and Collins. In essence, the UK Supreme Court reversed existing precedents and held that all clients of LBIE, whether their funds were actually held in the protected client money fund account or not, had a contractual right to receive client asset protection and, thus, should share in the pool of actual client money held by LBIE in a segregated client account.

### Regulatory Background—U.S. vs. U.K.

This author has written many articles recently on how futures customer funds must be held by a futures commission merchant ("FCM"), how the U.S. rules differ from similar client money fund rules in the U.K., and how initial margin is determined.<sup>3</sup> As noted in these articles, one of the most important customer pro-

tection themes underlying the Commodity Exchange Act ("CEA") and applicable Commodity Futures Trading Commission ("CFTC") regulations is the protection of customer assets, cash and collateral held by an FCM to margin the customer's underlying futures contracts. These rules are sacrosanct. Unlike U.S. checking, savings and stock brokerage accounts, which have insurance programs that are funded either by the government or industry firms (e.g., FDIC Insurance and SIPC Insurance), futures customers do not receive any special insurance proceeds if their FCM files for bankruptcy.<sup>4</sup> This absence of insurance also applies to cleared swap accounts.

To promote such customer asset protection, the applicable laws and regulations strictly govern how FCMs must properly fund the customer segregated accounts for both futures and cleared swaps and significantly restrict how FCMs may invest the customer funds. For example, one important restriction is included in CFTC

CONTINUED ON PAGE 3

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Regulation 1.25, which provides that an FCM may invest customer property in only certain permissible investments.<sup>5</sup> Industry practices hold the FCM liable for any losses that may result from such investments.

Equally as important, upon deposit in a protected customer segregated account, customer funds must remain in such protected accounts until returned back to the customer. This concept of customer segregation, in essence, forms a protective ring around the customer assets held by an FCM at a custodian bank and protects the customer assets from being held subject to the claims of the FCM's creditors. Applicable CFTC regulations provide an important protective barrier and require each FCM to maintain customer assets in accordance with these regulations. Therefore, once a customer trades futures (and now cleared swaps), its FCM must transfer funds held in the customer segregated account in the name of the FCM to another segregated account held at another custodian bank in the name of the derivatives clearing organization ("DCO").<sup>6</sup> Customer funds held by a DCO must also comply with these same applicable CFTC regulations. Similarly, if a U.S. customer wants to trade futures on a non-U.S. futures exchange, the funds used to margin the non-U.S. futures positions must be held in another protected account, called a secured amount account under CFTC Regulation 30.7.<sup>7</sup> Thus, at all times, customer funds used to margin futures contracts are held in these protective accounts, solely for the benefit of the customers.<sup>8</sup>

In the U.K., investment firms are similarly required to maintain client property in a "client money" account pursuant to the UK's Financial Services Authority ("FSA") Rules.<sup>9</sup> Unlike the U.S., where customers directly deposit their initial margin amounts into the FCM's customer segregated account, in the U.K., investment firms typically use an alternative approach in which customer property are first directly sent to the house account of the U.K. investment firm which then deposits the client money in the client money fund account.<sup>10</sup> The investment firm must identify customer assets held in the firm's house account, must reconcile the funds and then segregate the client monies. The one main issue that has been

addressed in prior U.K. cases involves what protections, if any, do U.K. customers receive in the event their investment firm does not properly hold their property in compliance with Chapter 7 of the Client Asset Sourcebook rules, commonly referred to as CASS 7.<sup>11</sup> In LBIE's case, not all of the customer funds were properly forwarded to the CASS 7 protected account. Therefore, the key issue before the UK Supreme Court was whether client money funds that were not deposited in the CASS 7 account by LBIE should receive the same customer asset protection that LBIE's customers received whose client money funds were actually deposited in the CASS 7 segregated account. This same issue arises with the insolvency of MF Global UK Limited ("MF Global UK"), the UK affiliate of MF Global Inc., as most of the funds transferred to MF Global UK were not held in its CASS 7 account.<sup>12</sup>

## Background of LBIE Cases from MF Global Inc.

Lehman Brothers Inc. ("LBI"), the U.S. registered broker-dealer and futures commission merchant, had opened a customer omnibus account on the books of LBIE to permit LBI's futures customers to trade on the various European exchanges. LBIE itself had several direct client contractual arrangements. Moreover, LBIE either was a direct general clearing member firm ("GCM") on certain European clearing houses, such as EUREX Clearing AG or LCH Clearnet SA, or had established its own customer omnibus clearing accounts with other third party clearing firms acting as a GCM on other European exchanges. Similarly, LBIE opened a customer omnibus account with LBI to allow its own direct customers to trade on U.S. exchanges.<sup>13</sup>

In two judgments handed down on December 15, 2009 and on January 10, 2010, Justice Briggs of the High Court held that LBIE's customers, with client money not segregated in accordance with the CASS 7 rules at the time of administration (e.g., on September 15, 2008), had no claim against the client money pool ("CMP") and thus would be treated as unsecured customers. This

ruling was similar to the decision issued in the *Global Trader* case noted above.

On August 2, 2010, the UK Court of Appeals reversed the High Court decisions and held that client money property should be treated equitably, whether the client monies were actually held in accordance with the CASS 7 rules or not. The UK Court of Appeals, in essence held:

1. The statutory trust over client money takes effect immediately upon receipt of the client monies by the UK investment firm.
2. CASS 7 requires client money pooling of all identifiable customer property wherever it may be found, and not just the amount of client money actually held in the protected client money account.
3. All clients have a contractual right to participate in distributions from the CMP, not just those customers whose property happened to be properly segregated.

This decision was appealed to the UK Supreme Court. The UK Supreme Court decision affirmed the UK Court of Appeals ruling.

## The U.K. Supreme Court Judgment on LBIE

The CASS 7 rules thus require investment firms, such as LBIE, to segregate client money received from clients. These rules create, in essence, a statutory trust over client funds and provide important priority treatment over such client funds held in trust.

The UK Supreme Court decision was based on three key issues, namely:

1. Whether the statutory trust created by the CASS 7 rules arise when the money is actually placed in the CASS 7 account or as soon as the firm receives the client funds?
2. Do the primary FSA client money pooling (“CMP”) arrangements apply to client money held in house accounts (e.g., not placed in the segregated account) or only to client money held in the segregated CASS 7 accounts?

3. Whether a client’s right to participate in distributions from the client money pool (“CMP”) is only available to clients whose funds were actually placed in the CASS 7 account (e.g., Segregated Customers) or also available to customers whose funds were not so placed (e.g., Unsegregated Customers)?

Both Justice Briggs of the High Court and the UK Court of Appeals held that, as to the first issue above, the statutory trust of client money occurs upon its receipt, and not whether the client funds are deposited in the segregated CASS 7 account. The UK Supreme Court was unanimous on this first issue and agreed with Justice Briggs and the UK Court of Appeals. CASS 7.7.2R states that “a firm receives and holds client money as trustee.” The UK Supreme Court stated that these words clearly mean that the trust over client money arises when that client money is received by the firm. When an investment firm, such as LBIE, utilizes the alternative approach noted above, then there must be a presumption that customer funds held in the firm’s house account must be client monies and thus are entitled to be deemed property held in trust.<sup>14</sup>

On this first issue, Lord Walker stated:

**“Where money is received from a client, or from a third party on behalf of a client, it would be unnatural, and contrary to the primary purpose of client protection, for the money to cease to be the client’s property on receipt, and for it (or its substitute) to become property again on segregation.”<sup>15</sup>**

He then stated:

**“The absence of express restrictions, under the alternative approach, on use of clients’ money while held in a house account does not mean that the firm is free to use it for its own purposes.”<sup>16</sup>**

He then concluded:

**“To allow a limited defect of the alternative approach to dictate the interpretation**

**of the essential provisions of Section 7.2 would be to let the tail wag the dog.”<sup>17</sup>**

The other two questions noted above received the greatest attention and debate. As to the second issue, Justice Briggs in the High Court held that the CMP shall only apply to funds actually held in the segregated client accounts whereas the Court of Appeals held that the CMP applies to all identifiable client money, wherever held, and thus should be pooled. The UK Supreme Court confirmed the UK Court of Appeals ruling. It stated that the pooling requirements apply to all client money, even identifiable client assets held in a house account and not deposited in the CASS7 account. In essence, the UK Supreme Court held that the true purpose of the CASS 7 protective scheme was to provide a high level of protection for all clients, including client funds held in the house account (e.g., the unsegregated account).<sup>18</sup>

Lord Dyson stated:

**“The phrase ‘client money account of the firm’ is not defined. As a matter of ordinary language, the phrase ‘client money account’ is capable of meaning (i) an account which contains or is intended to contain exclusively client money or (ii) an account of the firm which contains client money. Even when a firm is fully compliant, CASS 7 contemplates that client money will be held in the firm’s own account.”<sup>19</sup>**

Lord Dyson then confirms his position and states that the correct interpretation of the phrase “each client money account of the firm” is “the one which best promotes the purpose of CASS 7 as a whole.”<sup>20</sup> He then states:

**“To exclude identifiable client money in house accounts from the distribution regime runs counter to this policy. It creates what was referred to in argument as a ‘bifurcated’ scheme which provides clients with different levels of protection, namely a right to claim in the CMP under the CASS 7 rules for those whose money is held in segregated client accounts but no right (other than a right to trace in equity) to those whose money is held in the firm’s house accounts. The purpose of the**

**scheme (as required by the Directives) is to provide a high level of protection to all clients and in respect of client money held in each money account of the firm.”<sup>21</sup>**

As to the third issue, Justice Briggs held that only client money held in the CMP, that is, client money actually segregated, should participate in any distributions from the CMP. The UK Court of Appeals held that all clients with a contractual entitlement to CMP are entitled to such distributions, regardless of whether their client funds were actually segregated.

The majority of the Supreme Court (Lords Clarke, Dyson and Collins) agreed with the UK Court of Appeals on Issue #3. Lords Hope and Walker issued very strong dissenting judgments and held that the findings of Justice Briggs should prevail on this third issue.

The views of the majority appear to apply a theory of equitable fairness, that is, that all clients should be treated equitably. The majority clearly believed that the CASS 7 rules were intended to protect and provide a safeguard for all clients, regardless of whether LBIE treated their assets properly. In essence, clients have a contractual entitlement to client money protection. The majority held that the term “each client” in the CASS 7 rules must refer to each and every client for whom client money is identified, and that any and all funds remain fiduciary in character until all of the obligations arising from the fiduciary relationship are discharged.<sup>22</sup>

Lord Walker, on the other hand, took a more practical business approach. In his strong dissent, Lord Walker fully agreed with Justice Briggs. As to issue #3, relating to the basis of sharing the CMP, he acknowledged that Justice Briggs approached that issue as “a contest between what he called the contributions theory and the claims theory.”<sup>23</sup> In other words, do the protections provided by the CASS 7 rules refer to contractual or proprietary entitlement. He agreed that the contributions theory should apply.

Lord Walker then reasoned regarding the court’s responsibility::

**“The court has to give directions to the administrators on the basis of the as-**

**sumed facts set out in the SAF. Those assumed facts are stated for the most part at a high level of generality, and with an almost clinical detachment from what the judge referred to as LBIE's 'shocking underperformance'. We simply do not know how it came about that so much clients' money was paid into house accounts when it should have been segregated."**<sup>24</sup>

Lord Walker goes on to state:

**"Moreover client money held temporarily in a house account does not, in the eyes of trust law, 'swill around' but sinks to the bottom in the sense that when the firm is using money for its own purpose it is treated as withdrawing its own money from a mixed fund before it touches trust money."**<sup>25</sup>

In summary, the UK Supreme Court decision on LBIE expands the CMP, which affords priority treatment to customer funds, to include client money that LBIE should have, but failed to, properly segregate as CASS 7 funds. This landmark decision will have a major impact on new cases, in particular the recent MF Global UK insolvency, and may even result in new legislative and regulatory reforms. As just decided, mis-directed customer funds by a UK investment firm can and will be returned, and included with well-directed customer funds in determining the *pro rata* distribution. In other words, trust law prevails over location.

## MF Global's Bankruptcy

MF Global Inc., which was registered as both a broker-dealer and as a futures commission merchant, filed for bankruptcy on Monday, October 31, 2011.<sup>26</sup> Similarly, a liquidation proceeding was initiated in the U.K. on behalf of MF Global UK on the same day. KMPG LLP was appointed as the Administrator for MF Global UK. In its report, dated February 3, 2012, the Administrator stated that the U.S. SIPA Trustee appointed for MF Global Inc. has made a claim for an aggregate amount of \$742,151,834, which the U.S. SIPA Trustee claimed should have been held on a segre-

gated basis, and had made other claims for other amounts owed back to the U.S. SIPA Trustee for the benefit of MF Global Inc.<sup>27</sup> The Administrator further stated that none of the amounts sought by the U.S. SIPA Trustee had been held by MF Global UK in a segregated account in accordance with the CASS 7 rules as of the date of the appointment of the Administrator.<sup>28</sup> If the LBIE decision had reversed the decision issued by the UK Court of Appeals and ruled in favor of Justice Briggs, as the two dissenting justices concluded, then probably none of these amounts being sought by the U.S. SIPA Trustee would be returned back to the U.S. Now, in light of the UK Supreme Court holding, it would appear that all of these amounts will be grouped with those client funds actually held in accordance with the CASS 7 rules by MF Global UK, and thus receive a *pro rata* distribution of the total client funds held by MF Global UK. The big issue now is how much of these assets will now be returned back to the U.S. and when.

## Conclusion

The UK Supreme Court judgment now requires the Administrator to go back to the drawing board to determine the amounts to be distributed to all LBIE clients. This could take several months, and maybe even more litigation, to determine the accounting required and the *pro rata* customer distributions to the entire LBIE client base. LBIE filed for bankruptcy on September 15, 2008. Certain LBIE creditors were anticipating receiving their funds back even 3+ years later. Now, the timing for such distributions is not known. Lord Walker even acknowledged that the distributions of client money by the LBIE Administrator would take a very long time. The amount of any such distribution to the Segregated Customers will likewise be diluted. Query, how long may it be before any client funds are returned back to customers of MF Global UK, including assets transferred by MF Global Inc. to MF Global UK during those last days in October or will those funds be held indefinitely before any distribution may occur. A new special administration procedure for investment firms was created by FSA regulations issued on February 8, 2011, to expedite distributions in new insolvency matters.<sup>29</sup> These new procedures

should apply to MF Global UK and should thus help to further expedite the distribution of client funds. However, in light of the new UK Supreme Court judgment on LBIE, the FSA and the UK Parliament may now need to assess whether new legislative or regulatory changes are still needed to provide certain and prompt distributions of client funds after an investment firm fails. These changes, in my opinion, are drastically needed in order to maintain and further enhance London as a great financial center in today's global market.

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#### NOTES

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- 2 *In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986*, Hilary Term, 2012 UKSC 6 (February 29, 2102). (hereinafter referred to as the "Judgment"). A copy of the Judgment is available at: [http://www.supremecourt.gov.uk/docs/UKSC\\_2010\\_0194\\_Judgment.pdf](http://www.supremecourt.gov.uk/docs/UKSC_2010_0194_Judgment.pdf)
- 3 See *Are Customer Funds Segregated/Secured Amount Funds Properly Protected after Lehman?*, Journal on the Law of Investment & Risk Management Products, The Futures & Derivatives Law Report (November 2008); *Ask the Professor—What is Margin and How Is It (Or Should be) Determined?*, Journal on the Investment & Risk Management Products, The Futures & Derivatives Law Report (March 2009); and *Consumer protection: How U.K. Client Money Rules Differ From U.S. Customer Segregated Rules When a Custodian Firm Fails to Treat Customer Funds Properly*, Journal of

Taxation and Regulation of Financial Institutions (May/June 2011).

- 4 An interesting comparison involves the recent bankruptcies of Lehman Brothers Inc. in September 2008, which left no shortfall in the customer segregated fund account, and that of MF Global Inc. in October 2011, which apparently has resulted in a shortfall in customer funds, estimated to be approximately \$1.6 billion.
- 5 17 C.F.R. 1.25. Please note that the CFTC has recently adopted changes to CFTC Rule 1.25 which further restrict the types and usage of permissible investments and the amount of investment in such permissible investments.
- 6 A DCO is commonly referred to as a "clearing house" or "central counterparty" ("CCP").
- 7 17 C.F.R. 30.7
- 8 CFTC Regulation 1.20 also requires an FCM to receive an acknowledgement letter from the custodian bank or other depository that may hold futures customer assets which confirms that the custodian bank or depository may not apply any of the assets held in the protected customer account to satisfy any obligations owed by the FCM to the custodian bank.
- 9 See Section 139 of the Financial Services and Markets Act of 2000. The U.K. client money rules are reflected in Chapter 7 of the Client Assets Sourcebook ("CASS 7"), and are commonly referred to as the CASS7 rules.
- 10 Note that, under FSA rules, a customer may "opt out" of the protections provided by the client money fund rules. When a customer makes such an election, then, in theory, it is not entitled to any such client money protections.
- 11 See *In the matter of Global Trader Europe Limited (in liquidation)* (2009), EWCH 602 (Ch).
- 12 According to a recent Report of the UK Administrator for MF Global UK, approximately \$742 million transferred by MF Global Inc., the U.S. FCM, were not deposited in the CASS7 account opened by MF Global UK.
- 13 For a more detailed explanation of what took place during the week of September 15-19, 2008, please read the articles published by this author as listed in Note iii, *supra*.
- 14 See "eAlert of Allen & Overy, entitled "The client money lottery: you don't have to be in it to win it", 29 February 2012.
- 15 See Paragraph 63 of the Judgment.
- 16 *Ibid.*
- 17 *Ibid.*
- 18 See Paragraph 165 of the Judgment.

- 19 See Paragraph 162 of the Judgment.
- 20 See Paragraph 164 of the Judgment.
- 21 See Paragraph 165 of the Judgment.
- 22 See Paragraph 16 of the Judgment.
- 23 See Paragraph 68 of the Judgment.
- 24 See Paragraph 81 of the Judgment.
- 25 See Paragraph 65 of the Judgment.
- 26 See article written by this author on "*Ask the Professor: 'OMG. What did MF Global Do?' "*", Futures and Derivatives Law Report (November 2011 Issue, Vol. 31, No. 10).
- 27 See Paragraph 42 of the "Report for the Hearing on 3 February 2012" issued In the Matter of MF Global UK Limited (No. 9527 of 2011) filed with the High Court of Justice, Chancery Division of the Companies Court (hereafter referred to as the "UK Administrator's Report").
- 28 See Paragraph 44 of the UK Administrator's Report.
- 29 These special administration proceedings apply to any investment firm, as defined in section 232 of the Banking Act 2009 which have permission under Part 4 of the Financial Services and markets Act 2000 to carry on certain customer business