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Consumer Protection: How U.K. Client Money Rules Differ From U.S. Customer Segregated Rules When A Custodian Firm Fails To Treat Customer Property Properly

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HIGHLIGHT:
Following the collapse of Lehman Brothers in September 2008, there were major differences in the U.S. and the U.K. as to how customer assets were protected and returned. This article addresses the regulatory structures in place in each country regarding this essential customer protection feature, how those regulations vary, and what changes are still needed to ensure that customer assets held at a financial firm that collapses are timely returned. The article also analyzes how the current U.K. laws have proved to be ineffective in resolving this issue, the current status of U.K. judicial proceedings, and proposed new legislation pending in the U.K. that may resolve future financial insolvencies in that jurisdiction

CORE TERMS: customer, segregated, clearing, regulation, clearinghouse, non-u, cass7, shortfall, margin, custodial, deposit, broker-dealer, deposited, segregation, transferred, defaulting, registered, trading, lehman, non-regulated, calculation, opened, insolvency, collateral, designated, default, proprietary, commingled, permission, affiliate

TEXT:

Section 4d of the Commodity Exchange Act n1 and Commodity Futures Trading Commission (CFTC) Regulation 1.20 n2 require a futures commission merchant (FCM) to maintain and hold customer property that is 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 it in accordance with applicable laws and regulations. CFTC Regulation 1.20 states, in essence, that "[a]ll customer funds must be separately accounted for, and shall not be commingled with the money, securities or property" of the FCM or of any other person. n3 Similarly, in the U.K., pursuant to the Financial Services Authority (FSA) Client Asset Sourcebook (CASS), n4 client property--referred to there as "client money"--also must be segregated and be subject to a similar trust law concept. The purpose of both approaches is to establish procedures to ensure that customer property 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.

n1 U.S.C.A. § 6d.

n2 17 C.F.R § 1.20.

n3 See id. at § 1.20(c).

n4 See Financial Services and Markets Act, 2000, pt. X, c. 1, § 139 (Eng.). The U.K. client money rules are reflected in Chapter 7 of CASS, and are thus commonly referred to as CASS7.

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On September 15, 2008, Lehman Brothers Holdings Inc., the parent company of all Lehman Brothers entities and the NYSE listed public company (NYSE Symbol: LEH), filed for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York. On the same day, Lehman Brothers International (Europe) (LBIE), its principal U.K. subsidiary and the Lehman entity registered with the FSA, filed 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 Securities and Exchange Commission (SEC) and as an FCM with the CFTC--did not file for bankruptcy that day. In fact, LBI, having the requisite net capital to continue its business activities, continued to operate throughout the week of September 15-19, 2008, which gave its securities and futures customers the opportunity to transfer their respective open positions and collateral to other well capitalized brokerage firms or to liquidate their open positions during the 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. n5 LBI's customers were "made 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, PricewaterhouseCoopers was appointed as Administrator over the LBIE estate, a role similar to that of a trustee in U.S. bankruptcy proceedings.

n5 See Ronald Filler, "Are Customer Segregated/Secured Amount Funds Protected After Lehman?," 28 Futures & Derivatives L. Rep. 1 (Nov. 2008).

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U.S. REGULATIONS GOVERNING FUTURES ACCOUNTS

Substantial financial safeguards and customer protections exist within the U.S. futures industry that, as noted above, are designed to protect customer funds in the event of the FCM's bankruptcy. Customer assets held by the FCM on behalf of its futures customers (e.g., the margin amounts paid by the futures customers to fund their obligations to purchase or sell their underlying futures positions) are required to be maintained in at least one of two different types of customer accounts, namely a customer segregated account for all customer assets used to margin futures positions traded on a U.S. futures exchange (technically known as a "designated contract market") n6 or a secured amount account for all customer assets used to margin non-U.S. futures positions. n7

n6 17 C.F.R § 1.20.

n7 See CFTC Part 30, 17 C.F.R. pt. 30; 17 C.F.R. § 30.7.

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Types of Customer Fund Accounts. The two main types of customer fund accounts used by an FCM are segregated funds and secured amount funds. A third type of customer account--permitted under applicable laws and regulations but, due to recent FCM failures, not typically used today--is known as a non-regulated fund account. Each of the "buckets" described below contains funds used by customers to margin the relevant futures products; they differ as to whether the futures products are traded on U.S. or non-U.S. futures markets and, for non-US markets only, whether the customer is a U.S. or a non-U.S. entity.

Segregated Funds. A segregated fund account, established pursuant to Section 4d(a)(2) of the Commodity Exchange Act (CEA) n8 and CFTC Rule 1.20, n9 is referred to as the "customer segregated funds account." It holds the assets of all customers (U.S. and non-U.S.) deposited in conjunction with transactions on all U.S. futures markets. All customer assets are required to be held only in accounts maintained at custodial banks and other permitted financial institutions, including other FCMs and clearing houses that are registered with the CFTC as "derivatives clearing organizations" (DCOs).

All customer segregated accounts are required to be clearly identified as segregated pursuant to CFTC Rule 1.20. These segregated funds are not permitted to be commingled with the FCM's proprietary funds or used to finance its futures or broker-dealer businesses. The amounts held in the segregated funds accounts are calculated daily as required by CFTC Rule 1.32, and the FCM must take immediate action in the unlikely event that there is ever a shortfall in its segregated funds accounts. This daily calculation must be completed by each FCM by not later than noon on the next business day. However, the required segregated amount needs to be in a good control location n10 the night before. Otherwise, the FCM is deemed to be "under segregated," and, if the FCM is "under-segregated," this must be reported promptly to the CFTC and its respective Designated Self-Regulatory Organization (DSRO). n11 Given this same-day deposit requirement, most large FCMs will deposit a large amount of their own capital in the customer segregated account to ensure that such accounts are never "under-segregated." This capital infusion can amount to several hundred million dollars, depending on the total amount held in the segregation pool.

n8 7 U.S.C. § 6d(a)(2).

n9 17 C.F.R § 1.20.

n10 "Good control location" is mainly a term used by broker-dealers pursuant to SEC regulations but its meaning here implies an account established in accordance with CFTC regulations.

n11 See the Interpretative Statement issued by the CFTC on September 26, 2008, regarding funds related to cleared-only contracts. Interpretative Statement Regarding Funds Related to Cleared-Only Contracts Determined to Be Included in a Customer's Net Equity, Fed. Reg. 65,514, 17 C.F.R. § 190 (Nov. 4, 2008).

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Secured Amount Funds. The second type of account, governed by CFTC Rule 30.7, is known as the "customer secured amount account" and holds the assets of U.S. residents deposited in conjunction with their transactions on non-U.S. futures markets. These funds are also required to be held in accounts at banks and other permitted financial institutions, including non-U.S. clearing houses and members of non-U.S. exchanges, provided such non-U.S. clearing houses and non-U.S. member firms are deemed to be a "good secured" location. Like segregated funds, secured amount funds are not permitted to be commingled with the FCM's proprietary assets and are calculated daily and represent 100 percent of that day's customer requirements. n12 FCMs are permitted to secure more than the minimum requirement stated above and can elect to deposit all funds used to trade on non-U.S. markets by all of its clients, including foreign domiciled clients. Like the segregated funds noted above, the calculation for the secured amount requirements must be completed by the following morning but the secured amount requirement must be deposited in a good secured location the night before or the FCM will be deemed to be in default. n13 As noted above with customer segregated accounts, most large FCMs will also deposit their own capital in a secured amount account to prevent any under-funding from occurring.

n12 For those jurisdictions (e.g., Germany, Hong Kong, Korea) that do not provide the standard customer asset protection that requires the separation of a firm's proprietary assets from its customer assets, the FCM may deposit a corresponding amount of its own capital in a good control location, typically in the accounts at its respective custodial bank, to reflect the amounts as determined in its CFTC Rule 30.7 daily secured amount calculation (based on the amount for that trade date), in its U.K. FSA segregation daily calculation (based on the amount as determined on the trade date plus one day) and in its weekly SEC Rule 15c3-3 weekly calculation. This form of "double segregation" provides significant protections to an FCM's futures customers.

n13 Note that, pursuant to applicable CFTC regulations, an FCM is required to deposit all customer cash and securities in a customer segregated fund account but, in reality, is not required to place customer assets in a secured amount account. The FCM can elect to use its own capital to meet the minimum secured amount requirements.

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Non-Regulated Funds. The third type of account, normally referred to as the "non-reg account," contains the assets (cash and open trade equity) of non-U.S. customers deposited in conjunction with transactions on non-U.S. futures markets if such amounts are not included in the secured amount account as noted above. n14 An FCM, also registered as a broker-dealer, may use this third account type, which is governed by SEC Rule 15c3-3. n15 The amounts held in this account reflect the total of the credit balances calculated for each individual account owed by the FCM to its non-U.S. customers for transactions on non-U.S. futures markets less any deposits of cash or securities held with a clearing organization or correspondent clearing. n16 Any amounts held in a non-regulated account are not covered by the provisions of the Securities Investor Protection Act (SIPA).

n14 If the FCM is also registered as a broker-dealer, then these non-regulated accounts are maintained in accordance with SEC Rule 15c3-3. The Customer Reserve Formula calculation required by SEC Rule 15c3-3 is performed weekly, typically on each Monday, reflecting the amounts as of the previous Friday's close of business. The assets held in this account can not be commingled with the FCM's proprietary funds and are maintained in a designated Special Custody Account for the "Exclusive Benefit of Customers" (EBOC Account) at a designated custodial bank.

n15 17 CFR § 240.15c3-3.

n16 A broker-dealer ("BD") must maintain its securities customer assets in compliance with the SEC's "customer protection rule" (Rule 15c3-3), including maintaining cash in a special reserve account and maintaining fully paid and excess margin securities in a segregated account. See 17 C.F.R. § 240.15c3-3. In general, the securities accounts maintained at a BD will receive the benefit of expedited administration and the right to recover up to US $ 100,000 in cash or US $ 500,000 in securities if its broker-dealer were to become insolvent. Under such a scenario, customer assets held in a securities account would be administered pursuant to a proceeding brought by the Securities Investor Protection Corporation ("SIPC") pursuant to the Securities Investor Protection Act ("SIPA"). See 15 U.S.C. § 78aaa et seq. If the BD were also registered as an FCM, futures customers should understand, however, that SIPA rules specifically exclude futures customer accounts and their assets from its provisions. Most BDs have purchased a surety bond that provides protection in excess of the amounts provided under SIPC. However, this surety bond would, like SIPA, be limited to only the broker-dealer securities accounts and would not apply to the futures customer assets held by a joint BD-FCM.

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Further Restrictions on Placement of Client Funds. In addition to the segregation and secured amount requirements, CFTC regulations restrict where client funds may be placed. CFTC Rule 1.20 requires the FCM to maintain customer segregated funds, whether in the form of cash or collateral, either with a clearinghouse of a U.S. futures exchange registered with the CFTC as a designated clearing organization (DCO), in a customer segregated account with a bank, or with another FCM. In connection with its custodial arrangement, the FCM must obtain what is known as a "segregation acknowledgement letter," commonly known as a "seg. waiver letter," in which the respective custodial bank or FCM acknowledges and agrees that all assets deposited in this segregated account are for the sole benefit of the FCM's futures customers and are not subject to the claims of any of the FCM's creditors, including that bank or FCM, respectively. Similar letters must also be obtained for the Rule 30.7 secured amount account and the Rule 15c3-3 non-regulated account at the respective custodial bank. All customer assets are therefore held at all times in these accounts at the respective custodial bank or FCM, in accounts at the various clearing houses, or with other clearing brokers that act as clearing brokers on the various exchanges around the globe on behalf of the FCM.

Required Accounting and Reporting. An FCM is also required by CFTC regulations to properly account for and calculate, on a daily basis, both the amount required to be held in segregation and the amount that actually is in its customer segregated accounts. n17 Any deficiencies in the amounts required must be remedied and reported immediately to the appropriate regulators. Most large FCMs deposit a substantial amount of their own capital in the customer segregated account to provide excess funds in the event a futures customer does not timely meet its margin requirements. This capital infusion may also be used to satisfy customer claims in the event of the FCM's insolvency.

n17 See CFTC Regulation 1.20 which states:

> All customer funds shall be separately accounted for and segregated as belonging to commodity or option customers. Such customer funds when deposited with any bank, trust company, clearing organization or another futures commission merchant shall be deposited under an account name which clearly identifies them as such and shows that they are segregated as required by the Act and this part.

17 C.ER § 1.20(a). CFTC Regulation 30.7 contains similar language regarding the treatment of foreign futures and options secured amount accounts. See 17 § C.F.R 30.7.

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Similarly, to provide additional protections to its customers, the FCM must report, in accordance with applicable CFTC regulations, to the appropriate regulators within 24 hours if its net capital falls below the "early warning" level and must promptly add additional capital to bring its net capital above this level. n18 n18 See 17 C.F.R § 1.17.

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IMPACT OF FCM'S BANKRUPTCY ON CUSTOMERS' ASSETS
In the event of the FCM's bankruptcy, n19 futures customer assets are normally protected except as described below. First, assuming no material futures customer-related default exists or was the cause of the FCM's bankruptcy (e.g., the insolvency was the direct result of a non-futures customer or transaction), a bankruptcy filing should have no material impact on customers' assets held in the three aforementioned types of accounts. Under such circumstances, each account should contain 100 percent of the required amounts and should be transferred back to customers in an orderly fashion. An FCM bankruptcy would be administered under Chapter 7 of the U.S. Bankruptcy Code, which contains specific provisions for the protection of customers in the event of an FCM's insolvency. Under Part 190 of the CFTC's rules, the bankruptcy trustee would have the responsibility of returning the custodied assets back to each futures customer. Creditors of the FCM's bankrupt estate would have no claim to any of the assets held in the customer accounts. The assets would be held solely for the benefit of the FCM's futures customers.

n19 For a more detailed explanation of applicable laws and regulations affecting the bankruptcy of an FCM, see Subchapter IV of Chapter 7 of the U.S. Bankruptcy Code and Part 190 of the CFTC Regulations. 11 U.S.C. §§ 761-767; 17 C.F.R. pt. 190.

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If, on the other hand, the FCM's bankruptcy resulted from a futures customer's failure to deliver the required margin for its futures trading positions, and the default was greater than all of the shareholder equity of the FCM, then each of the customer accounts noted above held at the custodian bank (or an FCM) would be treated independently of each other. Customers' assets held in one of these accounts may not be used to satisfy any shortfalls in another account (e.g., the entity may not use the amounts held in the segregated account at the respective custodial bank or at a DCO to cover a shortfall held in the non-regulated account). However, as noted in greater detail below, a clearinghouse, including a DCO, may apply a clearing member firm's customer assets that are on deposit with that respective clearing house to satisfy margin amounts owed to the clearinghouse by that clearing member firm (and that clearing member firm only) for its customer accounts. In other words, customer assets held by a clearinghouse may not be used to cover a shortfall in the FCM's "house" account, nor may assets held at one clearinghouse be applied to cover a shortfall at another clearinghouse, unless a cross-margining arrangement exists with respect to the two clearinghouses.

The assets of an FCM's futures customers, which trade on the U.S. futures markets, are normally wired directly by those customers into the customer segregated account at the respective custodial bank. The custodian bank would typically maintain different segregated accounts to hold cash and any non-cash collateral, such as U.S. Treasury bills, respectively. This firewall between the bank and the FCM provides important protections to the FCM's futures customers. As noted above, the assets held in these accounts at the bank do not fall within the bankrupt estate and are reserved for payment to customers if the FCM files for bankruptcy. If the bank mishandles futures customers' assets held with the FCM, its full shareholder capital should stand behind the accounts. n20

n20 See also Brief of Amicus Curiae, filed by the CFTC on Mar. 28, 2011, in connection with the case of Frederick J. Grede, as Liquidation Trustee of the Sentinel Liquidation Trust v. Bank of New York Mellon Corp. and Bank of New York, on appeal before the U.S.

Court of Appeals for the Seventh Circuit (Consolidated Appeal Nos. 10-3783, 10-3990, and 11-1123), in which the CFTC argued that Bank of New York, as the custodian bank for Sentinel Management Group Inc. ("Sentinel"), a bankrupt FCM, violated § 6d(b) of the Commodity Exchange Act, 7 U.S.C. § 6d, in its handling of certain commodity customer segregated accounts established by Sentinel.

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If the FCM is required by an exchange to send cash or collateral to a DCO to meet its customers' initial or variation margin requirements, the required amounts are typically sent via wire transfer from the customer segregated account at the respective custodial bank or FCM to another customer segregated account held in the name of the DCO for the benefit of the FCM's futures customers. Therefore, at all times, assets of the FCM's futures customers who trade on U.S. futures markets are held in a customer segregated account at the FCM's or the DCO's custodial bank. Similarly, assets that need to be transferred to clearing brokers or clearinghouses outside the U.S. are also sent directly from CFTC Rule 30.7 Secured Amount Account at the bank to the required good secured location.

SPECIAL SHORTFALL ISSUES INVOLVING A DEFAULT AT A CLEARINGHOUSE

When an FCM, also acting as a Clearing Member Firm (CMF) at a futures clearinghouse, technically known as a DCO, incurs a shortfall in its customer segregated account held on the books of the DCO, and amounts are due from the defaulting CMF, the DCO, depending on its rules, may apply assets of non-defaulting customers of the defaulting CMF to satisfy the amounts owed by that CMF. In futures, all trading gains and losses are marked-to-market each trading day, with the total amount of the gains equaling the losses on any given trading day. This is commonly known as a "zero sum" game. Therefore, if a customer of a defaulting CMF loses such a large amount trading futures on a single trading day, and the CMF does not have the necessary capital to meet its financial obligation to the DCO, as required by the DCO's rules, then a shortfall occurs. The defaulting CMF thus owes this shortfall to the DCO which, in turn, will pay this amount to other customers who made the trading profit that day. And the DCO may apply the non-defaulting customer assets also held in the defaulting CMF's customer account to satisfy these financial obligations. While there has not been such a shortfall, these rules still exist and could one day be applied.

Following the recent passage of new financial regulatory reforms, known as the Dodd-Frank Act, n21 the CFTC has issued an Advanced Notice of Proposed Rulemaking which sought comments on three different methods of applying non-defaulting customer assets in the event of a CMF's default that leaves a shortfall with respect to OTC derivatives cleared by that CMF. Each of these three methods raises important issues, all involving different public policy concerns. The final CFTC rule may significantly change the futures model noted above.

n21 Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, 124 Stat. 1376 (2010).

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LEHMAN'S BANKRUPTCY AND ITS AFTERMATH

U.S. Events Following the Bankruptcy. LBI had opened a Customer Omnibus Account on the books of LBIE to permit LBI futures customers to trade on the various European exchanges. LBIE was either directly a general clearing member firm (GCM) on the clearinghouses in Europe, such as LCH Clearnet SA and EUREX Clearing AG, or had established its own customer omnibus accounts on the books of a third-party clearing firm on other European exchanges. LBI was the clearing member firm on the U.S. futures exchanges and had opened a futures customer omnibus account with other Lehman Brothers affiliates or third-party clearing firms in Canada and Asia. LBIE had opened a customer omnibus account on the books of LBI to allow its futures customers to trade on the U.S., Canadian, and Asian markets. All futures customer accounts were opened with either LBI or LBIE. n22 Note that LBIE had many direct futures accounts opened on its books, including some accounts, especially hedge fund accounts, that involved a prime brokerage and cross margin netting arrangement. LBI had similar arrangements with hedge funds on its books but also had a large number of futures-only accounts that were managed by large investment advisory firms.

n22 Over this same weekend, Merrill Lynch was acquired by the Bank of America and American International Group ("AIG") received a $ 85 billion loan from the U.S. Treasury. All of these events, and other similar concerns, created huge volatility in the global markets all at once. During this same period, many banks refused to issue credit to other financial institutions, including other banks. Over the weekend of September 19-21, 2008, the U.S. Treasury announced its $ 700 billion bailout which received Congressional approval on October 3, 2008.

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As noted above, the concept of segregated funds is designed to protect the cash and collateral deposited by futures customers to margin their futures positions. These regulations do not directly address the actual futures positions themselves. Given the uncertainty of the situation and the volatility in the marketplace, senior Lehman futures officials worked closely with their futures clients and governmental and exchange officials to transfer the client futures positions to other clearing firms in order to provide these customers with a new home that was properly capitalized. This process started immediately after LB Holdings filed its petition for bankruptcy in the U.S. but not so outside the U.S. PricewaterhouseCoopers, as the newly-appointed Administrator, did not permit the transfer of the open futures positions until late in the day on Wednesday, September 17, 2008, with the vast majority of the futures positions being transferred on Thursday, September 18, or Friday, September 19.

Most of the futures positions held by Lehman's customers, whether they were held on the books of LBI or LBIE, were either moved to other clearing member firms per the instructions of such customers by the close of business on Friday, September 19, or these remaining Lehman futures customers became futures customers of Barclays Capital Inc. (BCI), the U.S. affiliate of Barclays Bank PLC. BCI acquired all of the remaining futures customer accounts on the books of LBI after the close of business on September 19, 2008. Therefore, the system worked for the most part although, as noted above, quicker action was needed. Through the tremendous efforts of many governmental agencies, SROs, firms, exchanges, clearinghouses, and clients, the goal of transferring the open futures positions was effectively achieved within five days. This reflects the strong working relationships that exist within the global futures community. No other product area or industry can make a similar claim.

U.K. Background and Cases Involving Lehman. Following the bankruptcy filing by LBIE, as noted above, PricewaterhouseCoopers was named as the Administrator for the LBIE estate. Ever since then, customers of LBIE have been pursuing actions with the Administrator to collect back their assets held by LBIE. These claims have fallen within different groups, each having a common interest. One group, or tier, of customers involves assets held in compliance with the CASS7 rules, as noted above. A second group involves assets held outside the CASS7 rules, but which customers claim should have been held in accordance with those rules.

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 U.K. brokerage 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. n23 If, as 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 creditor claims. Conversely, those LBIE customers whose funds were held in accordance with CASS7 rules would be made whole; their assets would be unaffected 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 but which should have been--equally under trust law, effectively "saving" the latter customers at the cost of the former.

n23 Re Global Trader Europe Limited (in liquidation) (2009), EWHC 602 (Ch).

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In two judgments handed down on December 15, 2009, and on January 10, 2010, Judge Briggs 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. The Administrator, GLG Investments Plc Sub-Fund: European Equity Fund (GLG), and LBI sought permission to appeal directly from the U.K. Supreme Court to appeal the Court of Appeals decision.

Issues Raised by the Court of Appeals 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 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.

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 appeared 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 CEA Section 4d 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 clearinghouse 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 clearinghouse 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 they 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 clients with monies held in the CMP have a contractual right to distributions from the CMP. However, it goes further and seems to establish a property right, that is, that all clients 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.

Appeal of the U.K. Court of Appeals Order. In September 2010, the Administrator, GLG and Lehman Brothers Inc. sought permission to appeal directly from the Supreme Court. The applications for permission to appeal have been considered by the Supreme Court, and an order has been made by the Appeals Panel. The Appeals Panel has granted GLG permission to appeal but refused LBI's application because it did not raise an arguable point of law of general public importance. GLG is representing those clients for whom LBIE did segregate client money in accordance with the CASS7 rules. As of this writing, no decision has been made regarding the appeal made by the Administrator.

NEW U.K. ADMINISTRATION REGIME

On February 8, 2011, a Special Administration Regime (SAR) came into force in the U.K. regarding U.S. investment banks. The U.K. government, led by its Treasury and given the lessons learned from LBIE, created the SAR to give Administrators the ability to return client property held in trust as promptly as possible. n24 This SAR will apply to all U.K. investment banks regardless of their size and has three major objectives:

1. To ensure the return of client assets (including client money) as soon as reasonably practicable;
2. To ensure timely engagement with major infrastructure bodies and the Bank of England, the Treasury, and the FSA; and
3. To rescue the bank as a going concern or to wind it up in the best interests of creditors. n25

n24 See the Investment Bank Special Administration Regulations, 2011, SI 2011/245, for an Explanatory Memorandum on the new SAR and the Investment Bank (Amendment of Definition) Order, 2011, SI 2011/239, both issued on February 8, 2011.

n25 See "Special Administration for Investment Banks" (Allen & Overy, E-Bulletin, Feb. 24, 2011), available at http://elink.allen-overy.com/getFile.aspx?ItemType=Bulletin&id=a53a8e80-4a59-4620-807a-164f4b39d01a.

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Obviously, the first objective addresses one of the biggest concerns following LBIE's insolvency, namely, the return of client money. It appears, from the SAR, that the HM Treasury has decided that it is in the best interests to return all client assets as promptly as possible and there should be no distinction made between segregated and non-segregated assets. However, the SAR goes further and gives the Administrator the right to return client assets in the order that the Administrator deems to be the best approach and enables the Administrator to allocate any shortfall held in the client money account on a pro rata basis.

CONCLUSION

Time will tell whether the U.K. Court of Appeals decision will be the final outcome 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 percent of the time in the CMP and, as noted by the recently issued

SAR, to take immediate steps to return client assets as soon as is reasonably practicable. n26

n26 For more information on the LBIE matter, go to the website established by the U.K. Administrator, featuring updates on issues affecting LBIE claims. Lehmans Client Money, PWC UK, http://www.pwc.co.uk/eng/issues/lehmans_stakeholder_client_money.html (last visited Mar. 12, 2011).

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Another issue which needs to be addressed and which depends on future CFTC rulemaking involves how customer assets held by a defaulting FCM that is also a clearing member firm of a central clearinghouse (CCP) should or should not be fully protected if such a default results in a shortfall in the customer segregated account held at the CCP on behalf of the defaulting FCM. This article is in the works.