Neutral Citation Number: [2009] EWHC 3228 (Ch)

Case No: 7942 of 2008

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 15/12/2009

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (in administration)

Before :

MR JUSTICE BRIGGS

- -

Between :

(1) LEHMAN BROTHERS INTERNATIONAL (EUROPE) IN ADMINISTRATION

Applicant

- and -

(1) CRC CREDIT FUND LIMITED
(2) CLAREN ROAD CREDIT MASTER FUND LIMITED
(3) LEHMAN BROTHERS INC.
(4) LEHMAN BROTHERS FINANCE AG
(5) GLG INVESTMENTS PLC SUB-FUND: EUROPEAN EQUITY FUND
(6) GOLDMAN SACHS GSIP MASTER COMPANY (IRELAND) LIMITED
(7) PARAGON CAPITAL MANAGEMENT FUND LIMITED
(8) HONG LEONG BANK BERHAD
(9) LEHMAN BROTHERS HOLDINGS INC.

Respondents

- -
- -

Hearing dates: 9th – 24th November 2009

Approved Judgment

I direct that pursuant to CPR PD 39A paragraph 6.1 no official shorthand note shall be taken of this Judgment and that copies of this version as handed down may be treated as authentic.

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MR JUSTICE BRIGGS

APPEARANCES

Mr Iain Milligan QC and Miss Rebecca Stubbs (instructed by **Linklaters LLP**)
for the Administrators
Mr Charles Flint QC and Miss Felicity Toube (instructed by **Simmons & Simmons**)
for the First and Second Respondent
Mr John Jarvis QC, Mr James Evans and Mr Richard Brent (instructed by **Norton Rose LLP)**
for the Third Respondent
Mr Nigel Tozzi QC and Mr Jonathan Russen (instructed by **Field Fisher Waterhouse LLP**)
for the Fourth Respondent
Mr Antony Zacaroli QC and Mr Adam Al-Attar (instructed by **Allen & Overy LLP**)
for the Fifth Respondent
Mr Timothy Howe QC and Mr David Allison (instructed by **Allen & Overy LLP**)
for the Sixth Respondent
Mr Daniel Hubbard (instructed by **ELS Legal LLP)**
for the Seventh Respondent
Mr Nicholas Peacock QC and Miss Catherine Addy (instructed by **Baker & McKenzie LLP**) for the Eighth Respondent
Mr Richard Snowden QC and Mr Ben Shaw (instructed by **Weil, Gotshal & Manges)** for the Ninth Respondent
Mr Robin Knowles CBE QC and Mr Robert Purves
for the Financial Services Authority

Mr Justice Briggs :

1. This is a further application by the Administrators of Lehman Brothers International (Europe) ("LBIE") for directions pursuant to paragraph 63 of Schedule B1 to the Insolvency Act 1986. It has come to be known as the Client Money Application because the Administrators have sought to have determined, as far as possible, all issues concerning the interpretation and application to the administration of LBIE of the rules about client money in Chapter 7 of the Client Assets Sourcebook ("CASS7") issued by the Financial Services Authority ("the FSA") which stand in the way of progress towards a distribution of a substantial amount of client money to the clients of LBIE with beneficial interests in it pursuant to the statutory trust created by CASS7.

2. When first read, CASS7 appears to provide a relatively straightforward and intelligible code for the safeguarding of client money by regulated firms. In the barest outline, it provides for client money to be identified and promptly paid into segregated accounts, segregated that is from the firm's house accounts. It provides for client money to be held on trust, in substance for the clients for whom it is received and held. Finally in the event of the failure of the firm, the rules provide for the pooling of the client money, thus far segregated and held on trust, and for its distribution to those entitled to it under that trust, *pari passu* in the event of a shortfall.

3. In an ideal world, the flawless operation of the scheme created by the CASS7 rules would ensure first, that the clients' money could not be used by the firm for its own account and secondly, that upon the firm's insolvency, the clients would receive back their money in full, (subject only to the proper costs of its distribution) free from the claims of the firm's creditors under the statutory insolvency scheme. The rules would achieve those twin objectives by ensuring that, promptly upon receipt, client money was held by a firm as trustee, separately and distinctly from the firm's own money and other assets, and therefore out of the reach both of the firm (for the conduct of its business) and of the firm's administrator or liquidator upon its insolvency (for distribution among its creditors).

4. In the imperfect and hugely complex real world occupied by LBIE and its numerous clients, there has on the facts which I am invited to assume for present purposes been a falling short in the achievement of both of those objectives on a truly spectacular scale. This shocking underperformance has occurred for a number of reasons, of which two stand out as prime causes. The first is that (again on the facts which I am invited to assume) LBIE failed to identify as client money, and therefore also failed to segregate, vast sums received from or on behalf of a significant number of its clients. In this respect, the most significant group of clients whose money LBIE failed to segregate were its own affiliates, that is members of the Lehman Brothers group of companies of which Lehman Brothers Holdings Inc. ("LBHI") is the ultimate parent. Those affiliates have advanced client money claims against LBIE in aggregate exceeding US$3 billion. To put that extraordinary amount in perspective, the aggregate of the amounts actually held by LBIE in segregated accounts for clients for which it recognised a segregation obligation pursuant to CASS7 when it went into administration on the morning of 15th September 2008 had a face value of only US$2.16 billion approximately.

5. To the un-segregated affiliates' claims in excess of US$3 billion must be added claims of independent clients of LBIE who have challenged LBIE's treatment of its relationship with them as one of debtor/creditor rather than trustee and beneficiary, pursuant to the terms of its standard form contracts. The amount of under-segregation which may be attributable to that failure (if failure it be) has not been identified. In addition, LBIE routinely treated otherwise than as client money sums deriving from options and derivative OTC transactions with its clients, regardless of the terms of the agreements pursuant to which LBIE conducted such trading for those clients. The amount of potential segregation failure in respect of option transactions alone is said to have been US$146 million.

6. The second main reason for under-achievement of the objectives behind the CASS7 rules lies in the insolvent failure of another LBIE affiliate, Lehman Brothers Bankhaus AG ("Bankhaus"), with which LBIE had deposited no less than US$1 billion of segregated client money. Bankhaus was subjected to a moratorium by the German regulator on 15th September 2008, and insolvency proceedings in relation to it were commenced on 12th November 2008. The Administrators have been unable even to hazard a guess at the amount, if any, of client money which may be recovered from Bankhaus. Thus, even if there were no claims at all by clients whose client money LBIE failed to segregate, there exists a real risk that the shortfall on client account will exceed 40% due to the Bankhaus failure, quite apart from the costs and charges liable to be levied against the segregated fund in connection with its distribution, including the very large costs of this application.

7. The combination of a massive failure to identify and segregate client money, coupled with the credit loss shortfall attributable to the Bankhaus failure, has thrown up a series of fundamental problems in the interpretation and application of the rules in CASS7 to LBIE's business and insolvency. Those problems have been multiplied and aggravated by certain features of the "alternative approach", sanctioned by CASS7 and adopted by many large firms as the preferred method of achieving prompt segregation of client money. Under the alternative approach, client money is both received from and paid out to clients from the firm's house accounts, and internal reconciliations are conducted on every business day so as to top up, or as the case may be reduce, the amount held in segregated accounts by transfers from or to house accounts, so that the aggregate amount segregated is equivalent to the aggregate amount required to be segregated in respect of all qualifying clients. Inherent in the alternative approach is the mixing of client money with the firm's own money in house accounts, between receipt and segregation, but the rules are almost silent as to the consequences, in terms of what firms may or may not do with those of their house accounts which contain client money from time to time.

8. LBIE conducted its last reconciliation and segregation under the alternative approach during the morning of Friday 12th September 2008 by reference to the position as at close of business on the previous day. I shall refer to close of business on Thursday 11th September as the "Point of Last Segregation" ("PLS"), although that acronym has been used in submissions as a reference to the following morning, when the segregation was actually carried out. Because LBIE's going into administration was what CASS7 identified as a "Primary Pooling Event", 7.56 BST on 15th September has acquired the acronyms "Time of Appointment" or "T of A" and, for the purpose of analysis of the rules, the "PPE". I shall use the latter.

9. LBIE continued to do business (which included international business in numerous different time zones) between the PLS and the PPE, with consequential large inflows and outflows of client money (as between LBIE and its clients), none of which was reflected in any further internal reconciliation or segregation. I was told by the Administrators that there was a net outflow of client money from LBIE of approximately US$255 million, in the sense that if LBIE had remained in business during the morning of 15th September, an internal reconciliation and re-segregation conducted that morning by reference to close of business on Friday 12th September would have led to a payment out from the segregated accounts into house accounts of that amount. In fact, no such payment was made because, whether correctly or not, LBIE's going into administration brought its ordinary business activities, including daily reconciliations and segregation, to an abrupt end.

10. A further layer of complication and uncertainty is introduced by reason of a particular aspect of LBIE's business with its clients, namely the use of client money as margin for exchange-traded positions entered into by LBIE with intermediate brokers or clearing houses either expressly on clients' behalf, or on a principal to principal (but back to back) basis. Such margin was sometimes, but not always, held by LBIE in accounts with the relevant intermediate brokers or clearing houses. In such cases, where LBIE recognised that such money was client money, it was held in what are known as client transaction accounts. Those same accounts were used for the settlement of cash settled positions between LBIE and the relevant intermediate brokers or clearing houses on closing, so that profits were paid into, and losses debited from, those accounts.

11. It is common ground that client transaction accounts held by LBIE with intermediate brokers or clearing houses form part of the segregated accounts to be pooled as at the PPE and that, both before and after the PPE, LBIE's chose in action represented by its status as a creditor on each of those accounts was held by LBIE upon the statutory trust created by CASS7. Unlike a credit balance in an ordinary bank account, that chose in action has a constantly fluctuating value, since the client transaction accounts are liable to be credited and debited both by reference to changes in variation margin caused by the daily market performance of the underlying open positions, and by credits and debits made upon closing. Those changes continued during the period between the PLS and the PPE. They also continued thereafter, until the last of LBIE's open positions reflected in those accounts was closed, usually at the behest of the relevant intermediate broker or clearing house, exercising rights consequent upon LBIE's default triggered by its going into administration.

12. Finally, the pooled fund constituted as at the PPE was a multi-currency fund since, although LBIE segregated the bulk of the required amounts in US dollars, it held funds in local currencies all round the world in segregated accounts, namely the client transaction accounts. The Administrators have left that multi-currency segregated fund much as they found it. Viewed in terms of value in any one currency, even US dollars, the fund as a whole has therefore also continued to fluctuate in value due to movements in currency markets.

THE ISSUES

13. The questions which, by their application for directions, the Administrators have invited the court to determine number in excess of seventy, when all the multiple choice questions are added up. They fall under the following three broad headings:

A. Questions as to the constitution of the pool of assets to be distributed to clients (the Client Money Pool or "CMP").

B. Questions as to the identity of the clients entitled to share in the CMP, and as to the basis of their entitlement.

C. Questions as to the calculation and adjustment of clients' shares, in particular those caused by events following one or both of the PLS and the PPE.

14. During the course of some twelve days' oral argument (preceded by very comprehensive written submissions) it became apparent that a true appreciation of the meaning and effect of the CASS7 rules, and their implementation in relation to LBIE's failure, depended in particular upon the resolution of the following main issues ("the Main Issues"):

i) Does the statutory trust created by CASS7 take effect upon the receipt, or only upon the segregation, of client money?

ii) If upon receipt, what duties or restrictions are imposed by the rules, or by the general law, upon the use that the firm can make of client money while mixed with its own money pending segregation under the alternative arrangement?

iii) Does the CMP include all identifiable client money held by LBIE as at the PPE, whether or not actually segregated? If not segregated, how is it to be identified?

iv) If not, what provision do the CASS7 rules or the general law make in relation to identifiable client money which is not part of the CMP?

v) Do the rules or the general law require or permit a shortfall in the CMP as at the PPE to be topped up, either from other non-pooled identifiable client money, or from LBIE's general assets?

vi) Is the basis for sharing in the CMP the amount which ought to have been segregated for each client, or the amount which was in fact segregated (the claims basis or the contributions basis for sharing)?

vii) Upon what date are the clients' respective shares in the CMP to be calculated (the two candidates being the PPE and the date of distribution)?

viii) To what extent if at all can the firm's claims against its clients be set-off against the clients' entitlements to share in the CMP?

15. It will be apparent from that formulation of the fundamental issues that the analysis requires not merely an interpretation and application of the CASS7 rules, but also an appreciation of the relationship between those rules and the general law. An overarching question which arose at numerous stages in the analysis of the consequences of the rules not having been complied with by LBIE as they should have been is the extent to which the rules contain, expressly or by implication, their own prescriptions for protecting clients from the consequences of non-compliance and conversely the extent to which such protection is to be found, if at all, in the general law.

16. A constant and complicating feature of the analysis of the Main Issues is the extent to which a particular answer to one of them impacts upon the identification of the correct answer to others. There is no logical order of issues such that answers to those addressed first do not have to be constantly revisited by reference to the detailed consideration of those lower in the list. To take a simple example, it is much easier to contemplate a claims based entitlement to share in the CMP, if the CMP consists either of all identifiable client money or is liable to be topped up by reference to money which ought to have been, but was not, segregated. Each of those issues interacts upon the other. Thus a clear conclusion, as a matter of interpretation, in favour of a claims basis for sharing would reinforce arguments in favour of top up. Conversely a clear conclusion that the pool was limited to client money segregated by the time of the PPE would strengthen the argument for a contributions basis for sharing.

17. This tendency for issues to interact upon each other led to the parties to the application developing rival schemes for the interpretation and application of the rules as a whole, rather than freestanding answers to particular questions.

18. I shall in due course have to describe and contrast some of these holistic theories, both as originally presented and as substantially refined during the course of argument. They were, of course, developed by their protagonists so as to serve their own perceived ends, or the ends of the class which they were joined to represent.

19. The list of questions which the court has been requested to resolve was adjusted and supplemented at various stages during the hearing, without objection from any of the parties, as the argument developed. At the end of this Judgment I shall set out and answer the full list of questions in its final form, as it crystallised on 23rd November, pursuant to a final adjustment made on the previous day.

THE PARTIES

20. Although the questions have been presented to the court for determination in the form of an application for directions, the Administrators have been careful to seek out and join in a representative capacity sufficient clients of LBIE to ensure that there has been adversarial argument about each of the numerous questions presented for decision. In addition, a number of Lehman affiliates were joined to pursue their own interests. By an order made by Blackburne J at a CMC on 16th July 2009, synopses were prepared by the Administrators outlining the relevant factual position of each representative respondent, and each respondent was ordered to file a short position paper, identifying the direction which it would be inviting the court to make on each question in relation to which that respondent had been appointed to participate. In

due course, those position papers were followed by skeleton arguments or rather, having regard to their length, written submissions.

21. Pursuant to directions given by me on 25th September 2009, the various factual synopses have been consolidated into an agreed Statement of Assumed Facts ("SAF") which, although it continued to develop in certain respects during the hearing, when necessitated by the direction taken by oral argument, has served as the factual platform upon which the court has been invited to determine the question.

22. In respect of certain questions raised by the Administrators, they were unable to identify or persuade parties to engage in adversarial argument as representative Respondents on both sides of the question. This occurred only in very limited instances, and where it did occur, the Administrators took it upon themselves to advance a position by way of adversarial argument, just as trustees sometimes do in litigation about settlements and estates. Otherwise, the Administrators proffered submissions, in effect, as *amici.* They were of particular value on matters of practicability, fortified as they were by the Administrators' detailed experience of the affairs of LBIE gained since their appointment in September 2008. They appeared by Mr Iain Milligan QC and Miss Rebecca Stubbs.

23. In addition, the FSA was joined as a respondent, as both the propounder and guardian of the rules, and to assist the court. Through Mr Robin Knowles CBE QC and Mr Robert Purves the FSA played a prominent part both by written and oral argument in propounding a particular thesis as to how CASS7 should be interpreted and applied to the assumed facts relating to LBIE, a thesis which Mr Knowles submitted was directed to achieving, so far as possible, the purposes for which the rules had been formulated.

<u>The Representative Parties</u>

24. These parties formed a spectrum of competing and contrasting interests in the outcome of the questions raised by this application, ranging at one end from the interest of a wholly un-segregated client (that is a client whose money ought to have been, but was never, segregated) to the interests of an unsecured creditor of LBIE. I shall briefly describe the relevant facts about each representative respondent, by reference to the relevant part of the SAF, to the extent necessary to identify that respondent's particular interest in the outcome of the application.

25. At the wholly un-segregated end of the spectrum lay CRC Credit Fund Ltd ("CRC") and Claren Road Credit Master Fund Ltd ("Claren Road"), both of which appeared by Mr Charles Flint QC and Ms Felicity Toube. They were both prime brokerage clients of LBIE, for which no money was segregated by LBIE as at the PPE. On the assumed facts, LBIE should have segregated for CRC client money funds including US$52 million in connection with FX transactions and a cash balance worth approximately US$24 million in various currencies on other accounts. LBIE should have segregated about US$8.5 million for Claren Road as a result of matters occurring between the PLS and the PPE, and would have done so later on 15th September, had administration not supervened. A proportion of a further US$414 million, being a debt owed by LBIE to Claren Road as at the PPE should, on the assumed facts, also have been segregated.

26. Pursuant to Blackburne J's directions, CRC was to represent the un-segregated clients in relation to the majority of the questions, and Claren Road in relation to the remainder. In the event, CRC and Claren Road presented jointly, through Mr Flint, the un-segregated clients' arguments in relation to all questions. I shall therefore refer to them collectively, as CRC.

27. LBIE's fully segregated clients were represented by GLG Investments plc on behalf of sub-fund European Equity Fund ("GLG"). GLG held a futures and options account (or accounts) and a contract for differences account (or accounts) with LBIE. The correct amount of client money was segregated for GLG as at the PLS.

28. By the time of the PPE, GLG's equity surplus with LBIE decreased in value as the result of it receiving certain payments of cash from LBIE's house accounts between the PLS and the PPE. Accordingly, but for the Administration, the amount segregated for GLG would have been reduced by a reconciliation and re-segregation process later on 15th September. It was, in that sense, an over-segregated client as at the PPE.

29. GLG was also a debtor to LBIE as at the PPE, and remains a debtor, both in relation to agreements giving rise to its client money claim and in relation to other unrelated transactions with LBIE. GLG therefore had an interest in arguing against set-off, as between client money claims and debts owed. Furthermore, the value of GLG's open positions as at the PPE has since declined, so that GLG has an interest in arguing in favour of the PPE date for calculation of client money claims, rather than the date of distribution. Finally, LBIE's contractual obligations to GLG were owed either in US dollars or in currencies which have, since the PPE, depreciated in value against the dollar, giving it an interest to argue in favour of a conversion of currency claims to dollars as at the PPE, rather than a right to payment in the contractual currency, or conversion to dollars as at the distribution date.

30. GLG appeared by Mr Antony Zacaroli QC and Mr Adam Al-Attar, and played a major role in relation to most of the questions.

31. Goldman Sachs GSIP Master Company (Ireland) Ltd ("GSIP") held a futures and options account with LBIE and was fully segregated as at the PLS. Following the PPE its open positions with LBIE gained in value before they were closed so that, but for its Administration, LBIE would have segregated more money for GSIP following the PPE. Since LBIE held segregated money for GSIP in relation to its open positions in client transaction accounts, the gains in those positions before closure are likely to have been reflected in adjustments to those client transaction accounts, and therefore in a consequential adjustment in the value of the CMP which (by common agreement) includes those accounts.

32. Finally GSIP's client money claims against LBIE were and remain to a substantial extent contractually denominated in Japanese Yen, a currency which has appreciated substantially against the US dollar since the PPE. For those reasons, GSIP has an interest in arguing in favour of a distribution date calculation of client money entitlements, in relation both to positions open as at the PPE and to multi-currency issues, in conflict with the interests of GLG on that issue. GSIP has appeared by Mr Timothy Howe QC and Mr David Allison.

33. Paragon Capital Management Fund Ltd ("Paragon") is a BVI company which held a futures and options account with LBIE, on which there were no open positions as at the PPE, so that the credit balance on its account with LBIE consisted of free cash only. Paragon was a fully segregated client as at the PLS, and no events occurred between then and the PPE which would, but for Administration, have led LBIE to alter the amount segregated for Paragon as at the PPE, or thereafter. At no time on or after the PPE has Paragon been a debtor of LBIE.

34. Since there has been an aggregate diminution in the value of LBIE's clients' open positions since the PPE, in respect of which client money was or should have been segregated, Paragon's interests have been served by supporting GSIP in the advocacy for the distribution date for calculation of shares in the CMP. Furthermore, having no debt of its own to LBIE, Paragon's interests have been served by vigorous arguments in favour of set-off, so as to increase its share of the CMP as against the shares of other clients owing debts to LBIE. Paragon appeared by Mr Daniel Hubbard.

35. Hong Leong Bank Berhad ("HLBB") was a derivatives counterparty of LBIE with a claim as an unsecured creditor against LBIE, but no client money claim. It was therefore joined to represent the interests of LBIE's general estate, i.e. its creditors, including clients with no client money claim.

36. HLBB's interests have therefore been served by joining forces with GLG to resist the claims on the CMP of un-segregated or under-segregated clients (because the inclusion of such claims would reduce to vanishing point LBIE's prospect of obtaining a surplus from the CMP). Otherwise, HLBB has argued in favour of the unsecured creditors in relation to any issue from the outcome of which they might derive an advantage. Thus, for example, HLBB has argued that LBIE should be subrogated to the claims of such segregated clients of LBIE as have received securities or other assets from LBIE for the non-delivery of which (as at the PLS) LBIE had segregated money in those clients' favour. HLBB appeared by Mr Nicholas Peacock QC and Ms Catherine Addy.

<u>The Affiliate Parties</u>

37. Lehman Brothers Inc. ("LBI") is a Delaware corporation which has, since 19th September 2008, been the subject of a liquidation proceeding under the US Securities Investor Protection Act 1970, under the supervision of the US Bankruptcy Court.

38. LBIE transacted a very substantial volume of business both for LBI and for clients of LBI. Save for a little more than US$100 million which LBIE had segregated in relation to certain futures transactions carried out in respect of LBI's underlying clients, LBIE did not treat receipts of money from, or holdings of money for, LBI as client money, and did not therefore segregate them. LBI claims that LBIE should have done so, although its alleged liability to do so has not been admitted by the Administrators. For the purposes of this Application, I am required to assume that LBI was a substantial un-segregated client of LBIE (i.e. a client whose money should have been segregated), but the question whether LBI was entitled to have its money segregated by LBIE will, if relevant in the light of the outcome of this application, be likely to be the subject of major dispute.

39. Generally therefore, LBI's interests on this Application were served by making common cause with CRC, although in the event LBI sought to achieve the result contended for on behalf of un-segregated clients by a significantly different analytical route. LBI appeared by Mr John Jarvis QC, Mr James Evans and Mr Richard Brent.

40. Lehman Brothers Finance AG ("LBF") is a Swiss company, which went into Swiss bankruptcy liquidation on 22nd December 2008 at the direction of the Swiss Federal Banking Commission.

41. LBF's business included substantial OTC derivative trading with clients on its own account, for which purpose it hedged its exposure by exchange-traded margined transactions around the world. In respect of some of those transactions, LBF took advantage of LBIE's membership of the relevant exchanges, thereby becoming a client of LBIE in respect of positions taken on those exchanges by LBIE on its behalf.

42. LBIE did not at any time segregate any money for LBF. As at the PPE, LBIE had received the proceeds of the closing out of some of those transactions, but had yet to make payment to LBF. Furthermore, there existed a number of open positions on those exchanges as at the PPE. The result is that LBF claims to be a very substantial un-segregated client of LBIE, on the basis, as it claims, that LBIE should have segregated in the region of US$1.3 billion for LBF in respect of those transactions, as at the PPE. LBIE claims to be a creditor of LBF in its own insolvency process in Switzerland.

43. Being (on the assumed facts) therefore an un-segregated client of LBIE, LBF joined forces with CRC and LBI. It appeared by Mr Nigel Tozzi QC and Mr Jonathan Russen. Generally, they supported Mr Jarvis's analytical approach in preference to that of Mr Flint, but sought in significant respects to refine it.

44. Lehman Brothers Holdings Inc. ("LBHI") was the ultimate parent both of LBIE and all other companies in the Lehman group. It has since 15th September 2008 been in Chapter 11 Bankruptcy and subject to the supervision of the United States Bankruptcy Court for the Southern District of New York. LBHI controls some 2,000 subsidiaries, some of which are solvent, but many of which, like LBIE, LBHI and LBF are the subject of insolvency processes around the world.

45. LBHI has a subsidiary known as CMap Fund No 1 ("CMAP") which was a fully segregated client of LBIE as at the PPE. Otherwise, LBHI claims to be a very substantial unsecured creditor of LBIE, as do a number of LBHI's other subsidiaries. LBHI has therefore, notwithstanding the position of CMAP, generally supported, as being in its own interests, the position taken by HLBB as representative of LBIE's general estate, albeit with some differences and refinements of analysis. LBHI appeared by Mr Richard Snowden QC and Mr Ben Shaw.

THE ASSUMED FACTS

46. The Administrators have not requested the court to carry out a fact-finding process of any kind in relation to this application. As office holders they have of course a large fact-finding role of their own. The enormous size and complexity of LBIE's Administration means that they have by no means concluded their own investigations, still less reached factual conclusions in relation to all the matters which may be

affected by the interpretation and application of the CASS7 rules. They have therefore presented the issues of interpretation and application of CASS7 to the court on the basis of a platform of facts which they invite the court to assume to be true, rather than to confirm or reject. Those assumed facts are by no means merely a fiction. On the contrary, they represent the Administrators' best present estimation of the true facts, as the result of their continuing but incomplete inquiries. Indeed, the assumed facts have been discussed with the Respondents to this application and, where appropriate, adjusted in the light of their observations.

47. Nonetheless, the presentation of this Application on the basis of assumed facts involves neither the Administrators nor any of the other parties making any admission at this stage that those facts are true, either in general or in the particular. It follows that where in the remainder of this judgment I refer to matters of fact, the court is making no findings, one way or the other, about their truth or complete accuracy, capable of binding either the Administrators, any of the other parties or the classes represented by them. Some of the assumed facts, such as facts relevant to the question whether LBIE's affiliates were entitled to client money protection under CASS7, are likely (if relevant hereafter) to be the subject of very substantial dispute, in the event that differences between the Administrators and those affiliates cannot be resolved by agreement.

48. The relatively unusual process of determining questions of law by reference to assumed facts does not in my judgment significantly detract from the utility of this application. This is because the parties regard the assumed facts as a sufficient approximation to the underlying reality to ensure that the court's decision on the numerous questions of interpretation and application of the rules will not be significantly undermined by disparities between the assumptions and the realities which subsequently emerge. Of course, questions such as whether a particular affiliate was entitled to client money protection may, on a particular interpretation and application of the rules, have huge financial consequences, both for them, for LBIE's other clients, and for its unsecured creditors. For present purposes, it is sufficient for the court to assume, but without deciding, that the participating affiliates are entitled to such protection, in particular because it became a matter of common agreement during the course of this application that the status of affiliate did not, *ipso facto* and without more, deprive those entities of the status of client within the meaning of CASS7.

49. The assumed facts which I now describe are therefore those set out in the SAF which, as I have explained, has been put together mainly by the Administrators, but with the other parties' contributions, from synopses and other materials previously prepared pursuant to directions given by Blackburne J. I set out the assumed facts as they crystallised on 18th November 2009, shortly before the commencement of the parties' submissions in reply. I have already summarised, to the extent necessary, the assumed facts about each of the Respondents. For convenience, I have left as separate sections those additional facts which were added during the hearing by way of supplements to the SAF as it appeared at the beginning of the hearing. For convenience, I have also preserved the paragraph numbering of the SAF as transcribed into this judgment, omitting sections 3 to 11, which relate to the Respondents and which I have already summarised. I have removed all footnotes, and references to witness statements from which the facts have been obtained. I have

resolved certain very minor disagreements in relation to certain passages. Otherwise the text which follows is transcribed in its agreed form.

Statement of Assumed Facts

"1 Introduction

1.1 This statement sets out those facts which the Administrators and the respondents agree can be assumed for the purposes of the Administrators' application for directions as to LBIE's obligations in relation to the handling of client money. The facts set out below are assumed for the purposes only of this application. For the most part, the assumed facts reflect the Administrators' and/or the respondents' current understanding of relevant facts, although in certain instances facts have been assumed where the position is not currently clear or to facilitate representative respondents' appointments in respect of particular issues.

1.2 Unless otherwise indicated, capitalised terms used below have the meaning defined in the order of Mr Justice Briggs dated 25 September 2009.

2 Overview

2.1 Lehman Brothers International (Europe) (in administration) ("**LBIE**") is an unlimited English company. It is one of the companies within the global Lehman Brothers group of companies (the "**Lehman Group**") of which Lehman Brothers Holdings Inc. ("**LBHI**") is the ultimate parent. LBHI is a Delaware corporation.

2.2 At the core of the business of the Lehman Group was global investment banking. Until its collapse, it was one of the four biggest investment banks in the United States. It provided financial services to corporations, governments and municipalities, institutional clients and high net worth individuals. The business activities of the Lehman Group were organised in three segments: capital markets, investment banking and investment management. Those segments included businesses in equity and fixed income sales, trading and research, investment banking, asset management, private investment management and private equity. Some or all of these activities were undertaken by several different legal entities within the Lehman Group.

2.3 The Lehman Group was headquartered in New York, with regional headquarters in London and Tokyo, and many offices in North America, Europe, the Middle East, Latin America and the Asia-Pacific region.

2.4 The principal trading company of the Lehman Group within Europe was LBIE. LBIE's business involved the provision of a wide range of financial services to clients. In addition, LBIE also traded on its own account (termed 'proprietary' trading). LBIE carried out its business globally.

2.5 According to internal LBIE papers, LBIE had six divisions:

2.5.1 Prime Services: these services were provided across the whole of Europe and in the US and Asia. The Prime Services business involved providing a broad range of services to clients (usually hedge funds). LBIE provided such clients with trade execution, clearing and settlement, custodial and reporting services, entered into over-the-counter ("**OTC**") derivatives with them, and lent cash and securities to them. Such financing to each hedge fund was usually secured against the assets of the hedge fund that were held by LBIE.

2.5.2 Investment Banking: this included European advisory mergers and acquisitions, debt capital markets activities (primarily underwriting income) and equity capital markets activities (including underwriting).

2.5.3 Equities: this primarily involved trading with and on behalf of clients but included some proprietary trading. It involved dealing in cash-settled equities, convertibles and equity derivatives, and an equity strategies (event-driven) trading business.

2.5.4 Fixed Income: this conducted LBIE's activities with and on behalf of clients in various fixed income instruments, including collateralised debt obligations, credit derivatives, real estate and securitised products.

2.5.5 Investment Management: this included personal investment management activities and various private equity investments.

2.5.6 Principal Investing: this conducted cross-asset proprietary trading in equities, fixed income and derivatives. All transactions were for the account of LBIE, that is, not undertaken on behalf of clients.

2.6 LBIE entered into a number of different agreements with certain of its clients according to the types of services that LBIE provided to them. The agreements that LBIE used included: LBIE's standard terms of business; LBIE's 'title' and 'charge' international prime brokerage agreements; LBIE's customer account, prime brokerage and margin lending agreements (New York law-governed); LBIE's master institutional futures customer agreement; the ISDA (for OTC derivatives trading); various stock-lending and repurchase agreements; and LBIE's master custody agreement. Under some of these agreements, LBIE expressly agreed to provide client money protection. Under other of these agreements, LBIE sought to rely upon the 'total title collateral transfer' exemption from CASS (as defined in paragraph 2.9 below) to exclude those particular clients from client money protection.

2.7 LBIE entered into administration at 7.56am on Monday 15 September 2008 (the "**Time of Appointment**") by way of an administration order made by Mr Justice Henderson on the application of the directors of LBIE.

Regulation

2.8 LBIE is authorised and regulated by the Financial Services Authority (the "**FSA**"). It is or was also a member of various exchanges and clearing systems.

2.9 LBIE is not authorised by the FSA to take deposits. It was and is, however, permitted to handle client money and so was and remains obliged to comply with the FSA's Client Assets Sourcebook ("**CASS**") when doing so (although the extent of LBIE's obligations following the Time of Appointment is the subject of this application).

The alternative approach

2.10 To comply with its obligations under CASS to segregate client money from its own money, LBIE operated what is termed in CASS the alternative approach to segregation.

2.11 Under the alternative approach, client money would be paid directly into and out of LBIE's own bank accounts (or an Affiliate's bank accounts) and LBIE would segregate client money by making a single daily reconciling payment to (or withdrawal from) bank accounts used exclusively by LBIE in order to segregate client money. The amount of any such payment would be calculated by LBIE each business day morning based on data as at close of business on the previous business day. The client money segregated by LBIE would then be adjusted accordingly later that day.

2.12 In calculating how much money LBIE was required to segregate as client money, LBIE treated balances held on certain accounts held by it with clearing houses and brokers (termed its "**client transaction accounts**", as to which, see paragraph 2.43 below) as segregated. Further details of how LBIE's transaction accounts were operated are set out at paragraphs 2.42 to 2.49 below.

2.13 LBIE regularly handled money in more than 50 different currencies on a daily basis on behalf of more than 1500 clients across multiple business lines. As a result, LBIE often did not segregate client money in the same currency as that in which it was received. Instead it segregated client money mainly in US Dollars, although some client money, particularly where held with clearing houses, was held in other currencies. Prior to administration, where LBIE did not hold client money in the currency of receipt, LBIE bore the currency risk of fluctuations in the value of its client money balances.

2.14 As at the Time of Appointment, LBIE had last undertaken a reconciliation and segregation of client money on the morning of 12 September 2008 (the "**Point of Last Segregation**"), using data as at close of business on 11 September 2008 ("**COB 11.09.08**").

Client money components

2.15 When calculating the amount of client money required to be segregated by it, LBIE generally included a number of items or components. The extent to which LBIE segregated each of these components for its clients normally varied according to any contractual arrangements in place with those clients. For example, where agreements provided that LBIE held money under a "total title transfer" arrangement, LBIE did not segregate money arising under those agreements. Not all of the components segregated by LBIE would have been visible to its clients at the time of segregation (see in this regard, for example, the description of depot breaks in paragraph 2.16.5 below).

2.16 The components included in LBIE's calculation of amounts to be segregated were:

2.16.1 Cash balances: LBIE generally segregated money in respect of cash balances on custody accounts, dividends, redemptions and coupons arising on securities held by LBIE (or by a custodian on behalf of LBIE) for clients who had client money protection.

2.16.2 Futures: LBIE generally segregated an amount equal to its clients' free cash balances (if any), initial margin and unrealised gains in connection with their exchange-traded futures positions. LBIE also generally segregated premiums paid by clients in respect of their exchange-traded options positions.

2.16.3 Margin excess/margin: For certain other (but not all) prime brokerage clients, LBIE segregated an amount equal to those clients' margin requirements. For others (but not all), LBIE segregated money equal to any balances on their prime brokerage accounts in excess of their margin requirement (as determined under the prime brokerage agreement). For some others, LBIE did not segregate any amounts at all under the prime brokerage agreements.

2.16.4 Stock loan payables: LBIE generally segregated money in respect of stock loan fees, rebates and dividends payable to clients in connection with stock lending business. Fees and rebates were generally segregated on a monthly basis.

2.16.5 Depot breaks: LBIE segregated money where it was obliged to hold certain securities on behalf of a client or clients but did not in fact hold a sufficient number of securities to meet all of its clients' requirements (or believed it did not) (a "depot break"). Where a depot break occurred, LBIE would segregate an amount of money representing the value of those securities which it ought to have held but did not (or believed it did not). Money relating to depot breaks was segregated on a stock-line basis, rather than by reference to identified individual clients. This meant that LBIE would calculate how many securities of a particular type it was required to hold for all of its clients in aggregate and how many it was in fact holding. Where shortfalls (or perceived shortfalls) were identified, LBIE would segregate an amount equivalent to the value of the shortfall. The particular client to which the shortfall related (even if it was possible to identify such a client) was not identified by LBIE for the purposes of the client money segregation, since it was assumed that the latter was a temporary measure only until the depot break had been resolved.

2.16.6 Fails: Where LBIE entered into a delivery versus payment transaction but insufficient stock was delivered by one party against cash or vice versa, a "partial fail" occurred. Where the failure was on LBIE's side, LBIE would typically segregate as client money for that client an amount equivalent to the value of that part of the securities or purchase price it had not delivered until such time as the fail was fully resolved.

2.16.7 Unapplied credits: When credits were posted to LBIE's bank accounts, it was not always possible for LBIE to determine straightaway whether those amounts represented client money which was required to be segregated. These amounts were termed "unapplied credits" and LBIE segregated money in respect of them (pending determination of whether they constituted client money or not).

(i) In respect of unapplied credits which were between 0 and 3 business days old, LBIE segregated USD104.8 million each day in the period prior to and as at the Time of Appointment. This sum was referred to within LBIE as the client segregation "buffer". Its level was based on a formula which had been agreed with the FSA and which would be recalculated annually, by reference to a five week sample period. The level of the buffer was designed to protect those clients to whom LBIE was required to give client money protection. It would be included within the amount segregated by LBIE in its core client money bank accounts each day.

(ii) In respect of unapplied credits which remained unresolved after 3 business days of being credited to LBIE's accounts, LBIE would segregate an amount equivalent to those credits. At the Time of Appointment, the total amount segregated in respect of such "3 day plus unapplied credits" was USD53.5 million.

2.16.8 Manual items: Exceptionally LBIE deemed it necessary to segregate amounts in addition to those that formed part of the daily client money calculation. These would be calculated manually and segregated. At the Time of Appointment, only three items had been segregated manually, the aggregate value of which was less than USD12 million. Money segregated in respect of these items was included within the amount segregated by LBIE in its core client money bank accounts.

2.17 Segregation of money corresponding to each of the components described above was calculated by LBIE on the basis of the aggregate of individual clients' entitlements (on a "per account" basis for the majority of components). The amounts locked up by LBIE for futures and options clients did allow for some off-setting between LBIE and its clients - in limited circumstances, liabilities of futures and options clients in connection with their futures and options trading would result in LBIE reducing the amount segregated by it in respect of those clients' futures positions. However, LBIE did not otherwise operate in accordance with the 'Reduced client money requirement option' set out in paragraphs 18 and 19 of Annex 1 to CASS 7. In particular, it did not undertake any form of off-setting as between different components segregated for the same client.

Not all client money was "received" by LBIE

2.18 LBIE (or its Affiliates) received some client money from clients or third parties. An example would be a dividend payment paid to LBIE relating to securities held by it for a client. Typically, that money would be received by LBIE (or an Affiliate) by way of a transfer from a third party to one of LBIE's (or an Affiliate's) bank accounts. In such cases, LBIE (or the Affiliate) would receive a credit to one of its bank accounts.

2.19 However, not all money which was required to be segregated by LBIE was received by way of transfer from clients or third parties. An example of this type of client money would be a "manufactured dividend" due to a client in respect of shares which LBIE had "borrowed" from that client under a stock loan and which LBIE had then sold. In this situation, assuming LBIE was the party required to manufacture the dividend, there would be no "receipt" of any dividend money from a client or third party. Where LBIE gave the client client money protection, LBIE would transfer the relevant amount from its own funds to its core client money bank accounts pursuant to its client money segregation process.

LBIE's bank accounts

2.20 At the Time of Appointment, LBIE held more than 700 different bank accounts. These accounts were held with banks, including one of LBIE's Affiliates, and broadly fell into one of three categories, being:

2.20.1 The bank accounts and money market deposits which LBIE used exclusively for segregating client money held by it (outside of any client transaction account).

It was the aggregate balance on these accounts that LBIE would adjust each business day following its reconciliation and segregation exercise. These accounts are termed LBIE's "core client money accounts". At the Time of Appointment, four of these core client money bank accounts had credit balances totalling USD1.9 billion. One of these four accounts (in which LBIE had segregated USD1 billion of client money) was held with Lehman Brothers Bankhaus AG ("**Bankhaus**"). Bankhaus was placed under a moratorium imposed by the German regulator, BaFin, on 15 September 2008; and on 12 November 2008, BaFin announced that insolvency proceedings had been commenced in relation to Bankhaus. It is currently unclear how much, if any, of the money deposited with Bankhaus will be returned to LBIE and for this reason alone, if for no other reason, a significant shortfall in the client money pool is anticipated.

2.20.2 An intermediate category of accounts are referred to as LBIE's "non-core client money bank accounts".

There were more than 300 such accounts of which 37 have been identified as having credit balances as at or around the Time of Appointment. The total of such credit balances at or around the Time of Appointment was over USD175 million. Some of the names or account types by which these accounts were designated in LBIE's books and records appear to designate a client money account and LBIE sent client money trust notification letters in respect of some, but not all, of them. Others appear to have been linked to a securities account holding securities for LBIE's clients maintained by LBIE with a clearing system or custodian. However, in practice LBIE appears to have treated these accounts no differently from its house accounts (as to which see below). In particular, much of the money regularly received into these accounts was not client money and when client money was received into these accounts, LBIE would generally segregate an equivalent amount as client money in its core client money bank accounts.

2.20.3 LBIE's house accounts.

These accounts (of which there were more than 440, including sub-accounts) contained money which LBIE considered to belong beneficially to it, as well as any client money received following close of business on 11 September 2008 which had not been transferred to LBHI, as to which see paragraphs 0 onwards below.

Since LBIE operated the alternative approach to segregation (as to which see above), it is likely that some client money was received by LBIE into these accounts between COB on 11.09.08 and the Time of Appointment which was not segregated by LBIE prior to the Time of Appointment. Further, insofar as there are instances where LBIE received client money prior to close of business on 11 September 2008 which it should have segregated but did not, it is possible that LBIE's house accounts still contain that money. Certain of LBIE's house accounts regularly had house and client transactions processed through them. Of these accounts, as at close of business on 12 September 2008, 24 had credit balances totalling in aggregate approximately USD162 million and, as at close of business on 15 September 2008, 26 had credit balances totalling in aggregate approximately USD297 million.

Liquidity management process

2.21 LBIE's funding requirements across its many bank accounts would be managed each day as part of a liquidity management process which was intended to assist the Lehman Group to manage its global funding requirements more efficiently, for example, by allowing it to invest surplus funds centrally rather than leave funds in numerous bank accounts potentially earning less interest.

2.22 During the course of each business day, funding projections would be prepared estimating what cash would be required by LBIE on the following business day. In other words, an estimate would be made, at an aggregate level, of the anticipated and known payments that LBIE would need to make and that LBIE would receive. If LBIE's payments out were expected to exceed the receipts in, LBIE would obtain additional funding from LBHI (acting through its London branch) to meet the difference. If the receipts in were expected to exceed the payments out, surplus monies would be moved from LBIE to LBHI by debiting LBIE's bank accounts and crediting LBHI's bank accounts. The intercompany ledger account showing balances due between LBIE and LBHI would then be adjusted accordingly.

2.23 As well as LBIE's funding needs being determined at an aggregate level, they would also be determined on a bank account by bank account level as part of the liquidity management process. So, where a particular account held by LBIE was expected to have a surplus amount on the next business day, arrangements would be made to move that surplus. Depending on the amount of the anticipated surplus, the credit balance on such an account could be reduced to or near zero. Conversely, where an account was expected to require funding to make payments out, arrangements would either be made to fund that account accordingly, or particular payments otherwise due to be made to third parties from that account might instead be made by LBHI on LBIE's behalf, with the LBIE-LBHI intercompany ledger account being adjusted accordingly.

2.24 LBIE's funding requirements to meet its client money segregation obligation under CASS would also be managed as part of the liquidity management process. However, these calculations were performed each business day morning with LBIE segregating the appropriate amount later that same day. As a result, if LBIE required additional funding in order to meet any adjustment due to the amounts segregated in its core client money bank accounts, LBIE would seek same day funding from LBHI.

2.25 In the months leading up to and as at the Time of Appointment, LBIE was a net debtor of LBHI, such that payments made by LBIE to LBHI as part of the liquidity management process during that time only had the effect of reducing the aggregate amount owed by LBIE to LBHI. Where LBIE needed funding, this increased the amount it owed to LBHI.

2.26 All of LBIE's bank accounts were subject to the liquidity management process save that, in relation to LBIE's core client money bank accounts, surplus funds would only be withdrawn from these accounts where LBIE's reconciliation and segregation calculation permitted LBIE to reduce the amount of money segregated by it. Prior to the Time of Appointment therefore, client money first received into one of LBIE's bank accounts was regularly transferred to LBHI's bank account(s) each evening prior to LBIE segregating an equivalent amount the next morning. Given that, it is possible that client money received into LBIE's non-core client money bank accounts or house accounts between COB on 11.09.08 and close of business on 12 September 2008 would have been passed up to LBHI as part of the liquidity management process prior to the Time of Appointment.

2.27 Where LBIE's clients paid client money to LBHI instead of LBIE, the LBIE-LBHI intercompany ledger account would be adjusted to reflect the fact that money had been received into LBHI's bank accounts which was for LBIE. However, this would only reduce the amount owed by LBIE to LBHI; no actual cash payment would be received by LBIE in connection with that client money, unless LBIE needed money from LBHI in order to fund its client money segregation payment.

Margined transactions

2.28 As noted in paragraph 2.12 above, in addition to segregating client money in its core client money bank accounts, LBIE also treated the balances of its client transaction accounts as being segregated client money. In order to explain more about these and other transaction accounts, it is necessary first to explain how LBIE generally traded in exchange-traded derivative transactions.

2.29 Of the derivatives in which LBIE traded, most were margined transactions (i.e. margin was payable in respect of them). In practice, LBIE generally only segregated money in respect of exchange-traded margined transactions. LBIE did not generally segregate in respect of OTC derivatives, on the basis that the majority of OTC derivatives entered into by LBIE with its clients were undertaken pursuant to agreements containing total title transfer-type language. The term "margined transaction" in the context of this application is therefore generally used to mean exchange-traded margined transactions (i.e. futures and options).

2.30 In some instances, LBIE traded in margined transactions for its own account (an example of proprietary trading). In other instances LBIE traded with clients.

2.31 When LBIE effected a margined transaction with or for a client, LBIE would typically trade in the market in question through the relevant exchange, directly or via an intermediate broker.

2.32 In some instances, LBIE effected margined transactions on a principal-to-principal basis. In some other instances, it may have effected margined transactions as agent on behalf of the client.

> 2.32.1 Where LBIE traded as principal, this would give rise to a position in the market and a back-to-back position between LBIE and the client. Typically, a client could enter into a number of margined transactions in the same underlying futures contract, say, which would then be collectively referred to as that client's position in that futures contract (such position, whether in respect of a single or multiple transactions, a "**Client Position**"). Depending on the rules of the exchange and the positions of other LBIE clients at the time of the trade, LBIE's trade in the market would either create a corresponding position in the market exactly matching each Client Position or it would create a market position reflecting the net effect of its Client Positions in the relevant contract (in either such case, a "**Market Position**").
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> 2.32.2 Where LBIE traded as agent, there would be no separate, corresponding Client and Market Positions. Here, there would be only in effect the Market Position (or positions) opened by LBIE as agent for its client in the market.

2.33 Where LBIE was a member of the relevant exchange and a clearing member of the associated clearing house, LBIE would either:

> 2.33.1 open the Market Position directly with another member of the exchange; that contract would then be novated into two contracts such that LBIE and its original counterpart were each contracting with the clearing house, rather than one another; or
>
> 2.33.2 the contract would be concluded directly between LBIE and the clearing house so that no novation was necessary.

2.34 Where LBIE was not a member of the relevant exchange and clearing house, it would open the Market Position with a broker. That broker would either itself be a member of the relevant exchange and clearing house (and so in turn enter into its own back-to-back position with another exchange member and then the clearing house) or it would in turn contract with another broker who was a member of the relevant exchange and clearing house (who would then enter into its own back-to-back position, etc.).

2.35 In respect of a significant proportion of trading undertaken by LBIE (primarily in the US and Asian markets), LBIE traded with LBI as its broker.

Margin

For Client Positions

2.36 LBIE required its clients to pay deposits to LBIE (known as margin) in connection with futures positions (a type of margined transaction). The client would pay a one-off initial sum (known as "initial margin") upon opening a new position to cover prospective possible declines in the value of the client's position. In addition to this initial margin, the client would also on a daily basis pay additional sums (known as "variation margin") to cover any unrealised losses accruing on the client's position (i.e. losses which would accrue to the client, were it to close out its position at that time). Since the position continues until closed out or its maturity date, these are not realised losses and may be reversed by movements favourable to the client in the position prior to it being closed out or its maturity date, as the case may be. In that event, variation margin previously paid would typically be returnable to the client (e.g. by way of a credit to the client's ledger account maintained with LBIE). Whilst both initial margin and variation margin covered prospective losses rather than realised losses, variation margin reflected an actual market movement in the position, whereas initial margin merely reflected the future possibility of such a movement.

2.37 LBIE's futures clients would typically enter into multiple positions with LBIE and LBIE would only ever call for margin in respect of those transactions on a net basis. In other words, before calling for margin, LBIE would look at all of that client's open positions. Where that client's free cash balance, initial margin and unrealised profits on all of its open positions exceeded its unrealised losses, that client would have what was termed an 'equity excess'. Margin required to be posted (that is, initial margin plus, if appropriate, any variation margin required to be paid by the client) would be deducted from the client's free cash plus unrealised profits and LBIE would only require a client to pay variation margin to the extent that that margin exceeded the client's free cash balance plus unrealised profits.

2.38 It may assist to set out a simple example. A client ("**A**") opens an account, and LBIE requires it to deposit a sum of money up front, typically calculated by reference to the volume of trading which the client was proposing to do. In consequence, A immediately has a free cash balance available of, say, USD1 million. A wishes to open a futures position ("**P1**") which has an initial margin requirement ("**IM1**") of USD200k. Part of A's free cash balance is used to cover IM1, reducing A's free cash balance to USD800k; the total of A's free cash balance and IM1 is USD1 million. A then opens a second futures position

("**P2**"), which has an initial margin requirement ("**IM2**") of USD300k. Again, part of A's free cash balance is used to cover that initial margin. A's free cash balance now falls to USD500k. P2 increases in value to show an unrealised profit of USD 100k. LBIE then credits A's account with the unrealised profit of USD100k. A's equity excess is now USD1.1 million. Of the USD1.1 million, USD500k is free cash. When A wishes to open a third futures position ("**P3**") with an initial margin requirement ("**IM3**") of USD750k, A's free cash balance and unrealised profit of USD600k is insufficient to cover IM3. As a result, LBIE would have called for A to make a payment in of at least sufficient cash with which to meet the amount by which IM3 exceeds USD600k, being USD150k.

2.39 In respect of certain margined transactions, LBIE was required to segregate as client money an amount equivalent to the amount which it would be liable (ignoring any non-cash collateral held) to pay to a client in respect of that client's positions (e.g. using the example above, USD1.25 million, assuming that A makes the payment required in order to open P3). This would be calculated on the basis that each of the client's open positions was liquidated at the closing or settlement prices published by the relevant exchange or other appropriate pricing source and the client's account closed.

For Market Positions

2.40 The clearing house or broker would also require LBIE to pay initial and variation margin in order to cover LBIE's obligations to the clearing house under its Market Positions.

2.41 The amounts demanded as margin from LBIE by the clearing houses and brokers would not match what LBIE itself demanded from its clients. The clearing house or broker would only ever require margin on a net basis, taking into account all of LBIE's positions (whether proprietary, or whether relating to underlying positions with its clients or affiliates) held with that clearing house or broker on a particular account. The offsets inherent in the clearing house calling for margin from LBIE on a net basis meant that the net margin required by the clearing house would typically be smaller than the aggregate of the net margins required by LBIE from each of its clients.

Transaction accounts

2.42 LBIE held accounts with all of the clearing houses and brokers with which it entered into Market Positions and the clearing houses and brokers would adjust those accounts each business day to take account of new initial or variation margin paid by LBIE and unrealised profits and losses on LBIE's open positions. These accounts have been referred to as "transaction accounts." LBIE's transaction accounts were adjusted on a net basis only. So, as a result of the impact of other trading, a profit (or loss) by LBIE or a particular client would not necessarily result in an increase or decrease in the balance on the transaction account.

2.43 Some clearing houses and brokers permitted LBIE to maintain transaction accounts with them which were exclusively used for recording movements (including the payment of margin) relating to client generated positions and against which those clearing houses and brokers agreed they would not exercise rights of set-off relating to LBIE's proprietary positions.

Such accounts were treated by LBIE as client transaction accounts. Where such accounts were available, LBIE would also maintain a separate transaction account, which LBIE would use for proprietary or (subject to one exception mentioned in paragraph 2.59 below) Affiliate-generated positions.

2.44 At the Time of Appointment, LBIE operated client transaction accounts across 10 different clearing houses and brokers. As at close of business on 12 September 2008, LBIE's client transaction account balances had credit balances totalling in aggregate approximately USD260 million. LBIE treated the balances on its client transaction accounts as segregated for the purposes of its daily reconciliation and segregation exercise. To the extent that the aggregate of the amounts required to be segregated by LBIE as client money in connection with margined transactions exceeded the balances held on LBIE's client transaction accounts, LBIE would segregate the remainder in its core client money bank accounts as part of its daily client segregation calculation.

2.45 Where possible, LBIE would have one or more client transaction accounts for Market Positions reflecting Client Positions and one or more house transaction accounts for own-account trading or Affiliate-generated trading.

2.46 Where it was not possible for LBIE to maintain client transaction accounts with a clearing house or broker, a single transaction account would be maintained for all trading on LBIE's account (both client-generated and proprietary).

2.47 Where LBIE held such co-mingled single transaction accounts, LBIE did not include any part of the balance on these accounts in its client money segregation calculation and any money which LBIE believed needed to be segregated as client money in connection with positions held on these accounts was segregated by LBIE in one or more of its core client money bank accounts. That said, trades were undertaken by LBIE in respect of certain of LBI's underlying clients and booked to a co-mingled or house transaction account but no client money segregated in respect of them. At the Time of Appointment, LBIE operated "co-mingled" and house transaction accounts across 16 different clearing houses and brokers.

2.48 Following the Time of Appointment, the balances on all of LBIE's transaction accounts continued to be adjusted by the relevant clearing houses and brokers to take account of changes in the value of the margined transactions (whether client- or Affiliate-generated or proprietary) that were open at the Time of Appointment until those transactions were closed out.

2.49 All of the client-generated margined transactions that were open at the Time of Appointment have now been closed out. Between the Time of Appointment and the close-out of these transactions, some of the balances on LBIE's transaction accounts have increased in value, and some have decreased. To date, some clearing houses and brokers have yet to pay some or all of the closing balances on LBIE's transaction accounts to LBIE.

Movements between COB on 11.09.08 and the Time of Appointment

2.50 When LBIE went into administration at 7.56am on 15 September 2008, it had most recently performed its client money reconciliation and segregation exercise on the morning of Friday 12 September 2008 (being the Point of Last Segregation) using data as at COB 11.09.08. As a result, the amount of money segregated by LBIE as client money at the Time of Appointment did not reflect all of the events which had occurred between COB on 11.09.08 and the Time of Appointment. These events included:

2.50.1 Cash payments in excess of USD45 million of client money which were paid by LBIE to its clients from its house accounts (or by LBHI on behalf of LBIE). This money represented, for example, free cash balances on client custody accounts and margin excess on prime brokerage accounts and was paid in the ordinary course of LBIE's business.

2.50.2 Fluctuations in futures and options clients' net equity balances on margined transactions. During this period, the notional values of some clients' margined transactions increased; that of other clients decreased. At the Point of Last Segregation, LBIE segregated just under USD1.2 billion in respect of clients' net equity excesses on margined transactions (using data as at COB on 11.09.08). Between close of business on 11 and 12 September 2008, there was a net withdrawal of free cash balance by LBIE's segregated futures and options clients of approximately USD274 million, which was paid by LBIE from its house accounts (or by LBHI on behalf of LBIE). In addition, there was a net decrease in the market value of segregated clients' open positions of approximately USD14 million. The net effect of these movements was such that, absent administration, LBIE would on the morning of 15 September 2008 have adjusted the amount segregated by it in respect of futures and options positions downwards from USD1.2 billion to just over US0.9 billion. Whilst some of this reduction may have been captured in LBIE's client transaction accounts by reference to corresponding fluctuations in the Market Positions opened by LBIE relating to those Client Positions, some of it may not have been captured because LBIE did not hold client transaction accounts on all exchanges.

2.50.3 The resolution of partial fails in respect of which LBIE had segregated client money, and the occurrence of new partial fails for which nothing was segregated.

(i) As at the Time of Administration, a proportion of money segregated by LBIE as client money represented monies segregated in respect of partial fails, of which a number were resolved (i.e. the securities which had been owing to the clients were fully delivered to them or their accounts) in the period between COB on 11.09.08 and the Time of Appointment. It appears that during the course of Friday 12 September 2008 more than USD2.6 million out of the USD7.8 million segregated by LBIE in respect of fails as at COB on 11.09.08 were resolved.

(ii) In addition, new fails were identified during the course of 12 September 2008, in respect of which no money was segregated prior to the Time of Appointment.

2.50.4 The resolution of depot breaks in respect of which LBIE had segregated client money, and the occurrence of new depot breaks for which nothing was segregated.

(i) Prior to administration, LBIE would adjust the amounts segregated by it as depot breaks as the value of these securities in respect of which LBIE had segregated money fluctuated and as those depot breaks were resolved.

(ii) As at COB on 11.09.08, LBIE had segregated in excess of USD216 million in respect of depot breaks. During 12 September 2008, depot breaks worth nearly USD138 million were resolved. In addition, the net value of those securities in lieu of which LBIE had segregated money and which had not been resolved decreased by approximately USD390,000.

(iii) In addition, new depot breaks were identified during the course of 12 September 2008 in respect of which no money was segregated prior to the Time of Appointment.

2.50.5 Currency movements.

(i) As noted in paragraph 2.13 above, LBIE did not always hold client money in the same currency as that of receipt or of the liability giving rise to the obligation to segregate. Instead LBIE segregated mostly in US dollars. Where it did not hold client money in the same currency as that of receipt (or of liability), it bore the currency risk of fluctuations in the value of such client money deposits pursuant to CASS prior to the Time of Appointment. Accordingly, prior to administration, as part of its daily reconciliation and segregation exercise, LBIE would adjust such amounts as it had converted to an amount at least equal to the original currency amount (or the currency in which LBIE had its liability to its clients, if different) translated at the previous day's closing spot exchange rate.

(ii) At the Time of Appointment, the balances on LBIE's core client money bank accounts were all held in US dollars but the balances on its client transaction accounts were held in 30 different currencies (in addition to US dollars). Between COB on 11.09.08 and close of business on 12 September 2008, the aggregate value of non-US Dollar denominated currencies segregated by

LBIE at the Time of Appointment increased in value against the US Dollar by approximately USD3 million.

Movements after the Time of Appointment

2.51 Similarly, since the Time of Appointment, LBIE has not adjusted the amounts segregated by it in its core client money bank accounts (although as noted in paragraph 2.48 above, the balances on its transaction accounts (some of which LBIE treated as segregated) continued to be adjusted by the relevant clearing houses and brokers during this period until close-out of all open positions). As a result, the amount of money segregated by LBIE as client money does not reflect all of the events which have occurred since the Time of Appointment. These events include:

2.51.1 Continued fluctuations in futures and options clients' net equity balances up to the time of close-out or maturity of those clients' positions. Since all of these positions have now been closed-out or have matured, all client positions now have final actual, as opposed to notional, values.

2.51.2 Further resolutions of partial fails in respect of which LBIE had segregated client money.

2.51.3 Further resolutions of depot breaks in respect of which LBIE had segregated client money, and the occurrence of new depot breaks for which nothing was segregated. In addition, the values of the underlying securities in respect of those depot breaks which still exist will have continued to fluctuate.

2.51.4 Continued currency movements. Between close of business on 12 September 2008 and 4 September 2009, the aggregate value of the non-US dollar denominated currencies in LBIE's client transaction accounts as against the US dollar increased by approximately USD7 million.

2.51.5 In addition to the client money pool being made up of a number of currencies, the relative values of which continue to fluctuate, client money entitlements exist (and hence claims against the client money pool will be made) in a number of currencies, the relative values of which also continue to fluctuate. Until the Administrators know which clients are entitled to claim against the pool, and the permitted extent of their claims, they cannot quantify the value of these movements to date.

Potential instances of undersegregation

2.52 The Administrators have identified a number of instances in which it may be said that LBIE should have segregated money in accordance with its obligations under CASS where it did not. Examples are set out below.

2.52.1 LBIE did not segregate any money in relation to trading in any transactions, including margined transactions, carried out in respect of Affiliates trading on their own account. The amounts claimed by the Affiliates in connection with this exceed USD3 billion.

2.52.2 LBIE did not segregate any money in connection with certain complex arrangements that it had for the trading of various positions with its Affiliates, in connection with which amounts would fall due and payable as between LBIE and those Affiliates but would be posted to the relevant intercompany ledger account rather than always immediately paid.

2.52.3 LBIE often entered into agreements with its clients under which LBIE understood that client money protection would not be afforded to various types of money held by it for those clients. Where this was the case, LBIE did not generally segregate money on behalf of such clients. A number of clients with agreements of these types seek to argue that the particular language contained in their agreements was not effective to exclude client money protection, at least not in its entirety. Similarly, where clients entered into a number of agreements with LBIE which provided for differing levels of client money protection, those clients may seek to argue that amounts which were held by LBIE for them at the Time of Appointment were held pursuant to an agreement which provided for some client money protection as opposed to another which did not.

2.52.4 LBIE did not generally segregate as client money certain amounts relating to options transactions with its clients. This was the case for all clients, irrespective of whether they had in place title transfer arrangements with LBIE. Whilst LBIE segregated premiums received for sold options and variation margin on certain options and gains on options closed-out, it did not otherwise generally segregate for unrealised gains on open options positions. As at 12 September 2008, the approximate aggregate value of unrealised gains (not deducting unrealised losses) arising from options transactions which had not been segregated was USD146 million.

2.52.5 LBIE did not segregate any money in respect of OTC derivatives because all such money was regarded by LBIE as being held pursuant to total title transfers in accordance with CASS 7.2.3R.

2.52.6 From time to time operational errors occurred which led to a failure by LBIE to segregate an appropriate amount for a client.

Potential instances of oversegregation

2.53 The Administrators are aware of certain instances in which LBIE appears to have segregated money as client money for a client when it was not required to do so. For example:

2.53.1 LBIE would segregate in respect of delivery versus payment transactions as soon as delivery or payment did not take place on the due date (i.e. a partial fail occurred), rather than waiting to see whether delivery or payment (whichever was partially outstanding) did in fact occur by close of business on the third business day following the date on which the transaction had been due to settle (as permitted by CASS);

2.53.2 LBIE segregated USD104.8 million each day as the client segregation "buffer" in respect of unapplied credits which were between 0 and 3 business days old, some of which may have been referable to receipts from clients who were not entitled to client money protection; and

2.53.3 at the Time of Appointment, LBIE had segregated USD53.5 million in respect of such "3 day plus unapplied credits", some of which may also have been referable to receipts from clients who were not entitled to client money protection.

Wrongly de-segregated client

2.54 The Administrators are aware of at least one client for whom LBIE at one time held money on a segregated basis which was transferred out in circumstances where it should have remained segregated for that client. Prior to administration, LBIE had segregated just in excess of USD45,000 in respect of a coupon due to a client. Following segregation, an administrative error led LBIE to believe incorrectly that this coupon amount has been paid to the client. Accordingly, in its next calculation and segregation exercise, LBIE reduced the amount segregated by it in respect of this client. The error was not spotted prior to the Time of Appointment.

Potential difficulties in pricing open margined transactions as at Time of Appointment

2.55 As at close of business on 12 September 2008, LBIE had approximately 2,100 open positions relating to underlying trading with its clients in futures and options contracts traded across about 47 different exchanges. Of these exchanges, a number (e.g. Eurex and Hong Kong Futures Exchange) were open at the Time of Appointment.

2.56 In respect of those exchanges which were open at the Time of Appointment, it is unclear what data will be available to enable the Administrators to value open positions as at the Time of Appointment. In a number of instances, it is possible that there could be no relevant data available. The position could well vary between exchanges. It is also possible that the Administrators will encounter difficulties in establishing what information is available in relation to those exchanges of which LBIE was not a member.

2.57 The Administrators do not anticipate significant difficulties in pricing open positions that were traded on exchanges which were closed at the Time of Appointment. The appropriate price in respect of these positions would appear to be the closing settlement price on the previous business day.

Affiliates

2.58 LBIE did not generally segregate any money as client money for its Affiliates as it did not believe that it was required to do so, by CASS or otherwise.

2.59 LBIE did, however, segregate some money relating to futures and options trading undertaken by LBI with LBIE on behalf of certain of LBI's underlying clients.

2.59.1 At least as early as April 2008, LBIE indicated that it intended to segregate client money for LBI's underlying futures and options clients. Some emails were subsequently exchanged between LBI and LBIE in relation to LBI futures accounts and the extent to which those accounts contained co-mingled client and "house" (i.e. LBI) positions.

2.59.2 On 13 May 2008, LBI wrote a letter to LBIE in which LBI referred to five futures and options accounts held with LBIE and noted that funds deposited on these accounts belonged to LBI's foreign futures and foreign options commodities customers and should be segregated according to the US Commodities Future Trading Commission Regulations.

2.59.3 At a point prior to the Time of Appointment, LBIE began segregating client money in respect of amounts credited to three of these accounts maintained by LBI with LBIE (LBIE RISC account numbers 022-07000, 022-08001 and 022-08002). The balances on these segregated accounts related only to trading undertaken in respect of LBI's clients.

2.59.4 Of the two further accounts referred to in LBI's letter, at the Time of Appointment, only one was in credit (LBIE RISC account number 022-08000). The majority of the balance on this account was made up of amounts relating to LBI's proprietary trading, but also included an amount relating to trading undertaken in respect of LBI's clients. LBIE segregated some money in respect of this latter amount. However, nothing was segregated by LBIE in respect of amounts in this account relating to LBI's proprietary trading at the Time of Appointment.

First supplement to SAF: LBIE's house accounts/receivables

1. Cash on LBIE's house accounts

1.1 Bank accounts

1.1.1 At paragraph 2.20.3 of the SAF, it is noted that LBIE had more than 440 house bank accounts (including sub-accounts). Certain of these house bank accounts regularly had house and client transactions processed through them. Of the bank accounts referred to in the preceding sentence, at close of business on 12 September 2008, 24 had credit balances totalling approximately USD162 million and as at close of business on 15 September 2008, 26 had credit balances totalling in aggregate USD297 million.

1.1.2 Of LBIE's remaining house bank accounts, some had substantial credit balances as at the time of administration. While it appears that all of these accounts were subject to LBIE's liquidity management process, significant credit balances remained on a number of them (often on a relatively long-term basis) for a variety of reasons, including:

(i) collateral requirements – LBIE was required to hold collateral with various entities in connection with its normal clearing and settlement operations (e.g. with Euroclear);

(ii) regulatory requirements – LBIE was required to hold money in some jurisdictions to meet local regulatory requirements in relation to its branches or operational activities in those jurisdictions (e.g. in Korea);

(iii) FX restrictions – LBIE also held monies in some jurisdictions where it was not able to convert and repatriate its monies freely (e.g. in Argentina).

1.1.3 The accounts referred to in paragraph 1.1.2 were subject to LBIE's liquidity management process because, in calculating its funding requirements each day, LBIE would look at the balances across all of its bank accounts (save for its core client money bank accounts). Where balances on particular bank accounts needed to remain relatively static, the balance noted as being on that account in LBIE's funding projections would simply match the balance noted as being required for the next day on that account.

1.1.4 There were also credit balances on some other house bank accounts at the time of administration. These balances would be the result of, for example, settlement failures, or funds being received following close of business on 12 September 2008 - in effect "operational friction".

1.1.5 The Administrators believe that client money may regularly have passed through the accounts referred to in paragraph 1.1.1. They believe that it is less likely that client money would regularly have passed through LBIE's remaining house bank accounts, but they are not in a position to confirm whether it may be said in respect of any of LBIE's house bank accounts that no client money ever passed through them.

1.2 Transaction accounts

1.2.1 LBIE also held house transaction accounts with substantial balances on them at the time of administration. Where LBIE did not also hold a client transaction account with the relevant clearing house or broker, these house transaction accounts included balances relating to third party client-generated positions. In those circumstances, LBIE posted amounts with the relevant clearing house or broker but also separately segregated an amount in its core client money bank accounts in relation to the client money it believed it needed to hold in respect of those positions in order to comply with CASS.

1.2.2 Where LBIE did hold a client transaction account with the relevant clearing house or broker, its house transaction accounts would contain positions resulting from its own proprietary trading, as well as affiliate-generated positions (in respect of which LBIE did not generally segregate any amounts).

1.3 In aggregate, at the time of administration the balances across these house bank and transaction accounts totalled (subject to recovery) an amount in the billions of US dollars.

2 Receivables

2.1 Prior to LBIE's administration, broadly speaking receivables owed to LBIE (for its own account) were generally paid to LBIE where they related to securities and otherwise generally to LBHI.

2.2 Since LBIE's administration, receivables relating to:

2.2.1 securities held by LBIE in custodian accounts maintained by it prior to administration have generally been paid into the cash accounts LBIE had prior to the time of administration (although where possible they have since been transferred to bank accounts opened by the Administrators' in LBIE's name since administration ("LBIE's post-administration accounts"); and

2.2.2 securities moved by the Administrators to the new custodian appointed following administration have generally been and continue to be paid to LBIE's post-administration accounts.

2.3 Subject to paragraph 2.2.1, the Administrators have attempted to ensure that receivables are paid directly to LBIE's post-administration accounts (although, on occasion, payments have still been made to LBHI).

Second supplement to SAF: Interest earned on pre-administration client money

Interest was paid on LBIE's bank accounts and transaction accounts (including its core client money bank accounts and client transaction accounts) prior to administration. The amounts paid varied from one bank/clearing house/broker to the next. Interest continues to be paid on these accounts (where there is a credit balance) and accumulates in those accounts.

Some of the amounts held on LBIE's core client money bank accounts and some client transaction accounts have since been transferred into accounts opened in LBIE's name by the Administrators following the time of administration. These accounts have been and are being used exclusively to hold that client money. Some money recovered from other client transaction accounts has been transferred into other accounts opened in LBIE's name by the Administrators following the time of administration, into which post-administration client money has also been paid. These accounts also have been and are being used exclusively to hold client money save that certain post-administration payments have been credited to these accounts pending clarification of whether or not they are client money. Interest earned on all of these amounts is also accumulating in the relevant accounts.

Third supplement to SAF: LBIE's co-mingled house accounts

1. At paragraph 2.20.3 of the SAF, reference is made to certain of LBIE's bank accounts which regularly had house and client transactions processed through them. The SAF further notes that, of these accounts, at close of business on 12 September 2008, 24 had credit balances totalling approximately USD162 million. For the avoidance of doubt, these were the balances left on these accounts following completion of LBIE's liquidity management process for that day. In other words, these accounts were not swept to zero on 12 September 2008.

2. In relation to LBIE's non-core client money bank accounts much of the money received into these accounts was not money which was required to be segregated by LBIE for the purposes of CASS. Analysis indicates that less than 20% of the money which passed through these accounts in that week would have been money which LBIE was required to segregate. The Administrators have not so far undertaken a similar analysis of activity passing through the accounts referred to in paragraph 1 above. However, their expectation is that much of the money which passed through these accounts would not be money which LBIE was required to segregate for the purposes of CASS."

CASS7 – HISTORY AND ANTECEDENTS

50. CASS7 is part of the FSA's Client Assets Sourcebook ("CASS"), which itself forms part of the FSA Handbook. It includes rules, evidential provisions and guidance, and is made pursuant to legislative functions conferred on the FSA by the Financial Services and Markets Act 2000 ("FSMA"), and in particular those conferred by sections 138 (General Rule Making Powers), 139 (Miscellaneous Ancillary Matters), 149 (Evidential Provisions), 156 (General Supplementary Powers), 157(1) (Guidance) and 340(1) (Auditors and Actuaries). Section 138(1) empowers the FSA to make such rules applying to authorised persons as appear to it to be necessary or expedient for the purpose of protecting the interests of consumers. By section 138(7) "Consumers" includes persons who use, have used or are or may be contemplating using, any of the services provided by authorised persons in carrying on regulated activities. Section 139 provides that:

> "(1) Rules relating to the handling of money held by an authorised person in specified circumstances ("clients' money") may—
>
> (a) make provision which results in that clients' money being held on trust in accordance with the rules;

(b) treat two or more accounts as a single account for specified purposes (which may include the distribution of money held in the accounts);

…"

51. On 21st April 2004 the European Parliament and the Council of the EU adopted Directive 2004/39/EC on markets in financial instruments ("MiFID"). For present purposes, the following extracts from its recitals and articles suffice:

(Recital 2): "In recent years more investors have become active in the financial markets and are offered an even more complex wide-ranging set of services and instruments. In view of these developments the legal framework of the Community should encompass the full range of investor-orientated activities. To this end, it is necessary to provide for the degree of harmonisation needed to offer investors a high level of protection and to allow investment firms to provide services throughout the Community, being a Single Market, on the basis of home country supervision…."

(Recital 26): "In order to protect an investor's ownership and other similar rights in respect of securities and his rights in respect of funds entrusted to a firm those rights should in particular be kept distinct from those of the firm. This principle should not, however, prevent a firm from doing business in its name but on behalf of the investor, where that is required by the very nature of the transaction and the investor is in agreement, for example stock-lending."

(Article 13):

(1) "The home Member State shall require that investment firms comply with the organisational requirements set out in paragraphs 2 to 8."

(7) "An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency, and to prevent the use of a client's instruments on own account except with the client's express consent."

(8) "An investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the clients' rights and, except in the case of credit institutions, prevent the use of client funds for its own accounts."

(10) "In order to take account of technical developments on financial markets and to ensure the uniform application of paragraphs 2 to 9, the Commission shall adopt, in accordance with the procedure referred to in Article 64(2), implementing measures which specify the concrete organisational requirements to be imposed on investment firms performing different investment services and/or activities and ancillary services or combinations thereof."

52. On 10th August 2006 the Commission adopted Directive 2006/73/EC ("the MiFID implementing Directive"). Its relevant recitals and articles, for present purposes, are as follows:

> (Recital 4): "The organisational requirements and conditions for authorisation for investment firms should be set out in the form of a set of rules that ensures the uniform application of the relevant provisions of Directive 2004/39/EC [*i.e. MiFID*]. This is necessary in order to ensure that investment firms have equal access on equivalent terms to all markets in the Community and to eliminate obstacles, linked to authorisation procedures, to cross-border activities in the field of investment services."
>
> (Recital 5): "The rules for the implementation of the regime governing operating conditions for the performance of investment and ancillary services and investment activities should reflect the aim underlying that regime. That is to say, they should be designed to ensure a high level of investor protection to be applied in a uniform manner through the introduction of clear standards and requirements governing the relationship between an investment firm and its client…"
>
> (Recital 7): "In order to ensure the uniform application of the various provisions of [*MiFID*], it is necessary to establish a harmonised set of organisational requirements and operating conditions for investment firms. Consequently, Member States and competent authorities should not add supplementary binding rules when transposing and applying the rules specified in this Directive, save where this Directive makes express provision to this effect."
>
> (Article 4 (1)):"Member States may retain or impose requirements additional to those in this Directive only in those exceptional cases where such requirements are objectively justified and proportionate so as to address specific risks to investor protection or to market integrity that are not adequately addressed by this Directive, and provided that one of the following conditions is met:
>
> > (a) The specific risks addressed by the requirements are of particular importance in the circumstances of the market structure of that Member State;
> >
> > (b) The requirement addresses risks or issues that emerge or become evident after the date of application of this Directive and that are not otherwise regulated by or under Community measures."

Under Section 3 headed "Safeguarding of client assets", Article 16 headed "Safeguarding of client financial instruments and funds" provides that:

"1. Member States shall require that, for the purposes of safeguarding clients' rights in relation to financial instruments and funds belonging to them, investment firms comply with the following requirements:

(a) they must keep such records and accounts as are necessary to enable them at any time and without delay to distinguish assets held for one client from assets held for any other client, and from their own assets;

(b) they must maintain their records and accounts in a way that ensures their accuracy, and in particular their correspondence to the financial instruments and funds held for clients;

(c) they must conduct, on a regular basis, reconciliations between their internal accounts and records and those of any third parties by whom those assets are held;

(d) they must take the necessary steps to ensure that any client financial instruments deposited with a third party, in accordance with Article 17, are identifiable separately from the financial instruments belonging to the investment firm and from financial instruments belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection;

(e) they must take the necessary steps to ensure that client funds deposited, in accordance with Article 18, in a central bank, a credit institution or a bank authorised in a third country or a qualifying money market fund are held in an account or accounts identified separately from any accounts used to hold funds belonging to the investment firm;

(f) they must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of client assets, or of rights in connection with those assets, as a result of misuse of the assets, fraud, poor administration, inadequate record-keeping or negligence.

2. If, for reasons of the applicable law, including in particular the law relating to property or insolvency, the arrangements made by investment firms in compliance with paragraph 1 to safeguard clients' rights are not sufficient to satisfy the requirements of Article 13(7) and (8) of Directive 2004/39/EC, Member States shall prescribe the measures that investment firms must take in order to comply with those obligations."

Article 18 headed "Depositing client funds" provides that:

"1. Member States shall require investment firms, on receiving any client funds, promptly to place those funds into one or more accounts opened with any of the following:

(a) a central bank;

(b) a credit institution authorised in accordance with Directive 2000/12/EC;

(c) a bank authorised in a third country;

(d) a qualifying money market fund."

53. The United Kingdom's response to the obligations imposed by MiFID and by the MiFID implementing Directive took the form of the making by the Board of the FSA of the Client Assets sourcebook (MiFID Business) Instrument 2007 on 25th January 2007, which came into force on 1st November that year, and created a revised version of CASS which remained in force until, and including, the PPE. It was specifically designed to implement MiFID and the MiFID implementing Directive in the United Kingdom, and CASS7, headed "Client money: MiFID business", is entirely directed to the implementation of those parts of those Directives which relate to the safeguarding of client money. CASS7 has since been further revised, but those revisions took effect after the PPE. It has not been suggested that those amendments are of any relevance to this application.

54. CASS7 was not, of course, the first regulatory regime applicable to the holding of client money by investment firms such as LBIE. Earlier versions of CASS included client money rules, and those rules (and their predecessors) included the imposition of a statutory trust, and permitted the adoption of an earlier version of the alternative approach to client money segregation.

55. Although brief reference was made to the domestic antecedents of CASS7, and to consultation papers issued by the FSA in relation to them, it was common ground that the dominant feature of the background to CASS7, for the purposes of its interpretation, was constituted by MiFID and its attendant MiFID implementing Directive. They were, respectively, Level 1 and Level 2 Directives adopted using the Lamfalussy Process.

56. It is, equally, common ground that domestic legislation such as CASS7 which is made for the purpose of fulfilling the requirements of EU law contained in a Directive must be interpreted in the light of the meaning and purpose of the Directive. For that purpose the court may need to adopt a two stage approach, the first of which consists of interpreting the Directive, and the second of which consists of interpreting the domestic legislation in the light of the meaning of the Directive, thus interpreted: see generally HMRC v. IDT Card Services [2006] EWCA Civ 29. The first stage may require reference to different language texts of the Directive, to relevant *travaux préparatoires* and to any relevant decisions of the ECJ. In the present case, no ECJ decisions have been relied upon, and subject to one point to which I shall return, the *travaux préparatoires* added little to that which can be gained from the relevant parts of the text of the two Directives, read in their context. Mercifully, no-one suggested that enlightenment would flow from considering non-English texts.

57. At the second stage, the relevant domestic legislation must be interpreted in accordance with the following principles:

i) it is not constrained by conventional rules of construction;

ii) it does not require ambiguity in the legislative language;

iii) it is not an exercise in semantics or linguistics;

iv) it permits departure from the strict and literal application of the words which the legislature has elected to use;

v) it permits the implication of words necessary to comply with the Community law obligations; and

vi) the precise form of the words to be implied does not matter.

See Vodafone 2 v. HMRC [2009] EWCA Civ 446 at paragraph 37.

58. Nonetheless, the breadth of the obligation to construe in accordance with Community law obligations is constrained by the following requirements:

(a) The ascertained meaning should "go with the grain of the legislation" and be "compatible with the underlying thrust of the legislation being construed". It should not be inconsistent with a fundamental or cardinal feature of the legislation since this would cross the boundary between interpretation and amendment.

(b) The exercise of the interpretative obligation cannot require the court to make decisions for which it is not equipped, or give rise to important practical repercussions which the court is not equipped to evaluate.

See Vodafone 2 (supra) at paragraph 38.

59. For present purposes, MiFID and the MiFID implementing Directive appear to impose the following Community law obligations on Member States, in relation to firms such as LBIE doing business within the ambit of MiFID ("MiFID business") with clients. First and foremost, Member States are required to impose, by domestic legislation, specific obligations on investment firms taking the form of "concrete organisational requirements" with which they must comply: see MiFID Article 13(10) and MiFID implementing Directive Article 16(1) and (2).

60. Secondly, the purposes to be achieved by the imposition of those obligations and organisational requirements consist of the conferring of a high level of protection upon investors (MiFID Recital (2)) and, in relation to clients' funds, the safeguarding of the clients' rights in relation to those funds while held by the firm, so as both to prevent the use of client funds by the firm for its own account, and to protect the clients' rights in relation to those funds in the event of the firm's insolvency: see MiFID Article 13(8) and MiFID implementing Directive Article 16(2).

61. Thirdly, the safeguarding of clients' rights in relation to financial instruments and funds belonging to them is to be achieved by organisational requirements consisting of the following elements:

i) Accurate record keeping sufficient to enable firms "at any time and without delay" to distinguish assets held for one client from assets held for any other client, and from the firm's own assets;

ii) The conduct of regular reconciliations;

iii) The segregation of clients' assets and funds, whether held directly or through third parties, in such a way as to make them separately identifiable from assets and funds belonging to the firm;

iv) Adequate organisational arrangements to minimise the risk of loss or diminution of client assets or rights in connection with those assets as a result of misuse, fraud, poor administration, inadequate record-keeping or negligence.

See MiFID implementing Directive Article 16.1.

62. Fourthly, each Member State is to fashion the relevant obligations and organisational requirements imposed upon firms so as to be compatible with its own domestic property and insolvency law. In particular, to the extent that organisational requirements of the types identified in Article 16.1 of the MiFID implementing Directive would be insufficient to achieve the purposes of safeguarding clients' assets and funds from misuse, and from the firm's insolvency (as described above) because of particular provisions of that Member State's property and insolvency law, then the Member State must prescribe additional measures designed to achieve that result: see MiFID implementing Directive Article 16.2.

63. Save for the purposes of dealing with specific risks arising from the market structure of a particular Member State, or from risks or issues emerging after the date of application of the MiFID implementing Directive, Member States are not permitted to prescribe additional obligations or requirements beyond those specified in that Directive: see MiFID Recital (2) and MiFID implementing Directive Article 4. This is the "anti-gold plating" restriction.

64. It was implicit in various of the submissions made to me, in particular by Mr Knowles, Mr Flint and Mr Jarvis, that the objective of the Directives in affording a high degree of investor protection should be interpreted as requiring or permitting Member States to legislate in such a way as to adjust its domestic property or insolvency law so as to facilitate the achievement of that objective, and for the court to interpret or (in reality) revise aspects of English property and insolvency law to the same end. As I shall describe, these submissions were made with particular reference to the equitable principles by which, by tracing and following, a beneficiary is enabled to establish proprietary claims to substituted assets and to property in mixed funds, and to the rules which implement the principle that a company's assets are, upon its insolvency, to be distributed *pari passu* among its creditors.

65. In my judgment, it is clear that neither MiFID nor the MiFID implementing Directive imposes any such obligations, upon either the legislatures or the courts of Member States. On the contrary, the thrust of both Directives is that each Member State is to achieve a harmonised degree of protection for investors, but taking its domestic property and insolvency law as it finds it.

66. The starting point for this conclusion is the fact that Member States' domestic property and insolvency law is not, of course, harmonised. The achievement of a harmonised level of investor protection across 26 Member States with differing property and insolvency law is a formidable task. The *travaux préparatoires* for the MiFID implementing Directive includes the Technical Advice of the Committee of European Securities Regulators ("CESR") published in January 2005 in relation to possible implementing measures for MiFID (ref CESR/05-024c). At page 33 the Committee said this:

> "This advice identifies the organisational, procedural and contractual requirements that have to be put in place by investment firms to safeguard clients' ownership rights, especially in the event of their insolvency or actions brought against them by their creditors or by creditors of one or more of their clients. In view of the present lack of harmonisation within the European Union of national insolvency or property laws and of safekeeping and administration services, there cannot be uniformity as to the manner in which effectiveness of such requirements on the insolvency of an investment firm is achieved."

At page 35, as part of its Level 2 Advice, and under the heading "Arrangements designed to protect client assets", the Committee continued:

> "5. Such arrangements:
>
> (a) to the fullest extent practicable in accordance with the relevant systems of law, must ensure, as against a liquidator or creditor of the investment firm or in case of any judicial actions brought against the investment firm, that client assets are not available for satisfying an obligation of the investment firm itself;"

In my judgment that advice fully reflects the principle that, in a single market operating across un-harmonised property and insolvency law, the regulatory legislator was to be required, not to change or harmonise that law, but to prescribe obligations and organisational requirements which, if undertaken by firms, would achieve the purposes of MiFID in terms of investor protection, taking each Member State's property and insolvency law as it stood. I consider it clear that the Commission followed that advice in its adoption of the MiFID implementing Directive, which speaks of the Community obligation on Member States to impose obligations and organisational requirements upon firms. Critically, at Article 16(2), the remedy for difficulties created by national property and insolvency law is not an obligation to change that law, but to impose additional measures to be adopted by investment firms.

67. Further, I consider it plain that the two Directives seek to achieve the objective of securing a high level of protection for investors by requiring investment firms scrupulously to perform the prescribed obligations and organisational requirements, rather than by requiring Member States to legislate for a legal safety net to protect the clients of those firms which fail to comply. In short, as Mr Zacaroli put it at the beginning of his oral submissions, MiFID operates by directing Member States to implement measures requiring firms to do things. Beyond that, the Directives seek to ensure compliance by requirements for external compliance audit: see MiFID implementing Directive Article 20, and requires Member States to put in place procedures for monitoring firms' compliance and for the application of administrative sanctions to non-compliant firms. By contrast, nowhere in either Directive is there imposed an obligation to provide legal protection to clients' securities, funds or their rights in respect thereof in the event of non-compliance by firms, such that those assets or rights are nonetheless still protected from the consequences of a non-compliant firm's insolvency arising under the relevant Member State's domestic law.

68. Article 16(1)(f) of the MiFID implementing Directive speaks in terms of the need to minimise the risk of loss or diminution of client assets, or rights in connection with them, as a result of misuse, fraud, poor administration, inadequate record-keeping or negligence. Yet again, the prescribed remedy is that Member States must require firms to introduce their own adequate organisational arrangements to minimise those risks, rather than to provide a legal safety net when those risks materialise.

69. Finally, neither of the two Directives provides significant assistance in answering the question of how misfortunes which may affect a firm's investing clients as a class are to be shared between them, in circumstances where, through non-compliance or otherwise, the clients' securities and funds have not been preserved intact. In the present case, fundamental issues concern how the consequences of the triple whammy constituted by LBIE's failure to segregate, its insolvency, and the failure of one of its principal client account bankers are to be distributed among its clients. Put shortly, the two Directives appear to be largely neutral in relation to these questions about the sharing of misfortunes. By contrast CASS7, to which I now turn, deals expressly and unambiguously with some of those sharing questions. Nonetheless, it makes no express provision about numerous others.

INTERPRETING CASS7

70. I have already summarised the main principles applicable to the interpretation of CASS7, arising from the fact that it constitutes the United Kingdom's means of performing the Community law obligations imposed by the two Directives. To those principles I have concluded that it is appropriate to add the following, derived from an appreciation of the need to interpret CASS7 in its context.

71. The first derives from the fact that, subject to certain limited exceptions, CASS7 imposes a single regulatory code applicable to all firms doing any kind of MiFID business. It is, subject to those exceptions, truly a "one size fits all" scheme. The most important exception to that uniformity consists of the facility for firms to choose between the normal or alternative approaches to segregating client money, which I shall shortly describe in detail. Nonetheless, almost all the provisions of CASS7 are designed to apply to firms, large and small, which adopt either of those arrangements.

72. It follows that CASS7 should not be interpreted solely through the tunnel vision of its application to an extremely large complex firm such as LBIE, still less by exclusive reference to assumed facts about a firm which has spectacularly failed.

73. Secondly, it is equally wrong in my judgment to approach issues as to the practicality or utility of the provisions of CASS7 (and in particular the distribution rules which lie at the heart of this application) by exclusive reference to an assumption that there has been previous non-compliance by the firm with other provisions, before the particular provisions under review come into effect. On the contrary (and in this counsel were largely agreed although for different tactical reasons), since the thrust of the two Directives is that investor protection will be achieved by firms' compliance with regulatory regimes prescribed by Member States, the starting point for the purposes of interpretation should generally be the exact opposite. This is nonetheless only a starting point, and an approach to interpretation which studiously ignored non-compliance as part of the "what if" process of analysis would itself be, at least, incomplete.

74. Thirdly, although CASS7 appears at first sight to provide a complete and self-sufficient code for the protection of client money held by firms doing MiFID business, it should not in my judgment lightly be assumed that, in the absence of some express regulatory prohibition, a firm should be regarded as free to do what it likes with client money. The framers of the two Directives recognised that the effectiveness of the imposition of regulatory obligations and organisational requirements within any particular Member State depended upon the regulatory scheme being grounded upon, consistent with and responsive to that State's domestic property and insolvency law. In this jurisdiction, that law includes provisions which restrict what a trustee may do with trust property, without those restrictions necessarily having to be spelt out in the instrument (be it private or statutory) by which that trust is constituted.

75. Furthermore, the relevance of domestic law is not limited to issues as to whether a firm is subject to restrictions in relation to client money otherwise than as expressly provided in CASS7. The numerous gaps in the express provisions of the CASS distribution rules may themselves be capable of being filled by reference to the general law, rather than simply by a process of interpretation of the type explained in Attorney General of Belize v. Belize Telecom [2009] 1 WLR 1988, or by implication.

76. Nor should it be assumed that CASS7 prescribes a perfect, logical or fully coherent scheme. It is, as I shall show, patently inconsistent and flawed in certain significant respects, and while the court strives to make full and practical sense of any instrument which it is called upon to interpret, its task remains interpretation rather than improvement, still less perfection.

77. A further guide to the interpretation and application of parts of CASS7 is to be found in the decisions of Sir Andrew Park and David Richards J in Re Global Trader Europe Ltd (In liquidation) (No. 1) [2009] EWHC 602 (Ch) and (No. 2) [2009] EWHC 699 (Ch). Global Trader was a MiFID business firm which went into administration on 15th February 2008, and into creditors' voluntary liquidation on 17th June 2008. The decisions to which I have referred arose from an application for directions originally made by the administrators and continued by the liquidators, and the issues decided included a significant number of the issues now before the court. In relation to those issues the two decisions constitute persuasive but not binding authority on me, and it will be necessary to refer to each of them at various stages during the remainder of this judgment. I mention at this stage certain aspects of the Global Trader decisions relevant to the weight which I should attribute to them.

78. First, none of the parties before me were content that I should simply accept the Global Trader decisions as decisive of the issues common both to that application and to this one. Indeed, virtually every party submitted that one or other part of those decisions was wrong.

79. Secondly, Global Trader concerned a very much smaller firm than LBIE, and the amounts of money at stake were smaller by several orders of magnitude than those arising from LBIE's failure. For reasons deriving from the "one size fits all" nature of the client money rules, that is not of itself a reason for downgrading the weight to be given to the decisions of Sir Andrew Park and David Richards J, but considerations of proportionality inevitably led to some at least of the overlapping issues being given very much less attention during argument than that which has been devoted to them

on this application. For example, the decision of David Richards J as to the correct date for valuing clients' claims to the CMP followed a hearing at which oral submissions on that question were advanced only by counsel for the liquidators: see paragraph 3 of his judgment in Global Trader No 2.

80. Finally, it is possible that the need to review a much broader spectrum of issues relating to CASS7 than those calling for review in the Global Trader application means that a wider perspective may throw fresh light on the issues which were decided.

CASS7 – THE RELEVANT PROVISIONS IN DETAIL

81. For a regulatory code dealing with the holding and distribution of client money by investment firms, CASS7 is at first sight surprisingly short and apparently straightforward. Even including its Annex, it occupies only 38 pages, but it is supplemented by the constant use of italicised defined words and phrases, the full meaning of which is to be obtained from a 247 page Glossary, applicable to CASS as a whole. Although I shall follow that system of italicisation of defined terms when quoting from CASS7 (and from the Glossary), I shall not otherwise do so. Nevertheless, where in the remainder of this judgment I use words or phrases which are defined by reference to italicisation in CASS7, I shall use them in the same sense as is conveyed by those definitions. Any serious student of this Judgment would be well advised to have available a copy of CASS7 and (ideally) of the Glossary. Nonetheless I shall set out verbatim the main provisions relevant to the issues which I have to decide.

82. Leaving aside the Annex, CASS7 is unequally divided into two parts, namely 7.1 to 7.8, which constitute the client money rules (as defined), and 7.9 which constitutes the client money (MiFID business) distribution rules. I shall refer to the latter as "the distribution rules". Annex 1 augments and, as the case may be, assists in the interpretation of both sections of CASS7. It consists of guidance and constitutes what is defined as the "*standard method of internal client money reconciliation*". Every paragraph of CASS7 is given the label 'R' or 'G' to indicate whether it is a rule or merely guidance. Guidance is binding neither on the court nor on regulated firms and Mr Knowles on behalf of the FSA did not shrink from a submission that in certain important respects, the guidance was, quite simply, wrong. Nonetheless, some very important provisions in CASS7 appear only as guidance, including both the normal and alternative approaches to segregation, and the whole of Annex 1.

83. Unfortunately, patent errors in CASS7 are not limited to the guidance. For example, I have just described the definition in the Glossary of *client money rules* where that defined phrase is used in CASS7 as meaning CASS7.1 to CASS7.8. Nonetheless, CASS7.1.1 R begins inauspiciously with the phrase "this chapter (the *client money rules*) applies to …" suggesting that the client money rules consist of the whole of CASS7. As will appear, this inconsistency is not merely of semantic interest, because Mr Knowles and others based a major submission upon the assumption that provisions of CASS7.1 to 7.8 continued to apply during the period following a Primary Pooling Event, which appears to be governed by the distribution rules in CASS7.9. As will also appear, there is an obvious and very important typographical error in 7.7.2R, the rule which sets out the terms of the statutory trust of client money.

84. CASS7.1, headed "Application and Purpose" provides at 7.1.1R:

> "This chapter (the *client money rules*) applies to:
>
> (1) a *MiFID investment firm*:
>
> (a) that holds *client money*; or
>
> (b) …
>
> (2) …
>
> unless otherwise specified in this section."

85. It is common ground that LBIE is and has at all material times been a MiFID investment firm. The definition of client money is however important, and the relevant part of it appears in the Glossary as follows:

> "(2A) (In CASS6 and CASS7 and, in so far as it relates to matters covered by CASS6 or CASS7, *COBS*) subject to the *client money rules*, *money* of any currency that a *firm* receives or holds for, or on behalf of, a *client* in the course of, or in connection with, its *MiFID business*."

86. Within that definition, *money* is itself broadly defined as meaning "any form of money, including cheques and other payable orders". The word *firm* needs no further elucidation and, although the word *client* is the subject of a detailed and sophisticated definition, the agreement of the parties in this case that the definition does not, *ipso facto*, exclude LBIE's affiliates makes it unnecessary for me to delve further into it.

87. *MiFID business* is defined in the Glossary as "*investment services and activities* and, where relevant, *ancillary services* carried on by a *MiFID investment firm*". It is common ground that LBIE is a MiFID investment firm but that, in relation to some of its dealings with its affiliates, it carried on business which was not exclusively MiFID business.

88. CASS7.1.16G, headed "General purpose" provides that:

> "(1) *Principle* 10 (Clients' assets) requires a *firm* to arrange adequate protection for *clients'* assets and the *firm* is responsible for them. An essential part of that protection is the proper accounting and treatment of *client money*. The *client money rules* provide requirements for *firms* that receive or hold *client money*, in whatever form.
>
> (2) The *client money rules* also implement the provisions of *MiFID* which regulate the obligations of a *firm* when it holds *client money*."

89. Notwithstanding that the Glossary contains the bespoke definition of client money which I have described, the whole of CASS7.2 is devoted to an attempt to amplify that definition. Unfortunately, in at least one major respect, its internal

inconsistencies serve as much to confuse as to clarify. Section 7.2.1R begins with an almost verbatim recitation of the definition in the Glossary which I have already set out, supplemented by the concluding words "unless otherwise specified in this section."

90. Section 7.2.3R, preceded by the heading "Title transfer collateral arrangements" provides that:

> "Where a *client* transfers full ownership of *money* to a *firm* for the purpose of securing or otherwise covering present or future, actual or contingent or prospective obligations, such *money* should no longer be regarded as *client money.*"

This paragraph gives effect to Recital 27 of MiFID, and constitutes an important exception to the MiFID client money regime. One of LBIE's standard forms of client agreement, namely its Title Transfer IPBA, sought to take advantage of this exception, and claims that it was ineffective for that purpose constitute the basis of some of the non-segregation (or under-segregation) claims which have given rise to this application. For the purposes of interpretation, it is sufficient to note that the exception constituted by CASS7.2.3 may lead to the result that no part of a client's business with a firm gives rise to client money, or that only part of it does, with the consequence that, in relation to the rest of it, the relationship between the firm and the client is more like that of banker and customer.

91. Under the heading "Money due and payable to the firm" CASS7.2.9R provides that:

> "(1) *Money* is not *client money* when it becomes properly due and payable to the *firm* for its own account.
>
> (2) For these purposes, if a *firm* makes a payment to, or on the instructions of, a *client,* from an account other than a *client bank account*, until that payment has cleared, no equivalent sum from a client bank account for reimbursement will become due and payable to the *firm*."

By contrast, under the heading "Discharge of fiduciary duty", CASS 7.2.15R provides that:

> "*Money* ceases to be client money if it is paid:
>
> (1) to the *client*, or a duly authorised representative of the *client*; or
>
> (2) to a third party on the instruction of the *client*, …
>
> (3) into a bank account of the *client* (not being an account which is also in the name of the *firm*); or
>
> (4) to the *firm* itself, when it is due and payable to the *firm* (see CASS7.2.9R (Money due and payable to the firm)); or

> (5) to the *firm* itself, when it is an excess in the *client bank account* (see CASS7.6.13R(2) (Reconciliation discrepancies))."

CASS7.2.17R then provides:

> "When a *firm* draws a cheque or other payable order to discharge its fiduciary duties to the *client*, it must continue to treat the sum concerned as *client money* until the cheque or order is presented and paid by the bank."

92. I shall return to the meaning of *client bank account* in due course. For present purposes, it is sufficient to note that it is one of the types of account into which a firm is permitted to segregate client money. CASS7.2.9R(1) appears to be in conflict with the combined effect of CASS7.2.15R and 17R. Those provisions all appear to attempt to define circumstances when money (having originally been client money) ceases to be client money. Paragraph 7.2.9R(1) appears to suggest that this occurs when the money becomes properly due and payable to the firm, whereas paragraphs 7.2.15R(4) and (5) suggest that money (presumably segregated because it is client money) which becomes due and payable to the firm only ceases to be client money when it is actually paid (out of a segregated account). CASS7.2.17R tends to confirm the latter analysis, albeit in the separate context of client money paid out to the client, rather than to the firm.

93. In my judgment, and notwithstanding submissions to the contrary, the particularity of CASS7.2.15R clearly overrides the generality of CASS7.2.9R(1), by specifying the point of payment as the time at which money ceases to be client money. I have concluded that the explanation for the apparent discrepancy is not because the draftsman decided to include two conflicting provisions in consecutive pages of CASS7, but rather because the expressions *money* and *client money* in CASS7.2.9R are used not strictly as references to money as a species of property, but rather to a monetary obligation or entitlement, whereas the same expressions are used in the strict proprietary sense in CASS7.2.15R.

94. The same occasional tendency to use the expression *client money* as a reference to a monetary obligation or entitlement appears in CASS7.2.13G under the heading "Commission rebate", where it is provided that:

> "When *commission rebate* becomes due and payable to the *client*, the *firm* should
>
> (1) treat it as *client money*; …"

On the face of it, it is difficult to identify a rebate (whether of commission or of anything else) as a species of property, rather than as a monetary obligation or entitlement. The only sense which I have been able to make of CASS7.2.13G(1) is that it imposes an obligation on the firm to appropriate and segregate as client money a sum of its own money on account of a commission rebate obligation, unless that obligation is discharged by immediate payment to the client, as contemplated by sub-paragraph (2).

95. These occasional lapses in the strict use and application of defined terms in CASS7 serve as a warning to be cautious before assuming either that phrases (defined or undefined) are always used within CASS7 in the same way, or that defined expressions are always used strictly in accordance with their definitions, whether in the Glossary or elsewhere.

96. Section 7.3, headed "Organisational requirements: client money" is worth quoting in full:

> "Requirement to protect client money
>
> 7.3.1R A *firm* must, when holding *client money*, make adequate arrangements to safeguard the *client's* rights and prevent the use of *client money* for its own account
>
> [Note: article 13(8) of *MiFID*]
>
> Requirement to have adequate organisational arrangements
>
> 7.3.2.R A *firm* must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of *client money*, or of rights in connection with *client money*, as a result of misuse of *client money*, fraud, poor administration, inadequate record-keeping or negligence.
>
> [Note: article 16(1)(f) of the *MiFID implementing Directive*]."

97. As the notes imply, both those rules consist of almost verbatim quotations from the two Directives. By being described as Requirements, they properly treat as fundamental objectives of CASS7 two of the main purposes of the provisions of the two Directives relating to client money.

98. CASS7.4 deals with segregation of client money. Under the heading "Depositing client money" section 7.4.1R provides that:

> "A *firm*, on receiving any *client money*, must promptly place this *money* into one or more accounts opened with any of the following:
>
> (1) a central bank;
>
> (2) a *BCD credit institution;*
>
> (3) a bank authorised in a third country;
>
> (4l) a *qualifying money market fund*."

As the following note explains, this is an incorporation of Article 18(1) of the MiFID implementing Directive. Section 7.4.3G explains that money deposited with a qualifying money market fund must be dealt with in accordance with the MiFID custody chapter, i.e. outside the client money rules.

99. CASS7.4.7R requires that a firm which does not deposit client money with a central bank must exercise all due skill, care and diligence in the selection, appointment and periodic review of the credit institution, bank or qualifying money market fund where the money is deposited. That duty applied to LBIE's choice of Bankhaus as the repository of a substantial part of its segregated client money. The SAF makes no assumptions, one way or the other, as to whether LBIE complied with that duty in relation to Bankhaus. CASS7.4.8R,CASS7.4.9G and CASS7.4.10R makes additional provisions with respect to that duty.

100. CASS7.4.11R under the heading "Client bank accounts" requires that:

> "A *firm* must take the necessary steps to ensure that *client money* deposited, in accordance with CASS7.4.1R… is held in an account or accounts identified separately from any accounts used to hold *money* belonging to the *firm*."

Again, this replicates Article 16(1)(e) of the MiFID implementing Directive.

101. CASS7.4.12G then explains that:

> "A *firm* may open one or more *client bank accounts* in the form of a *general client bank account*, a *designated client bank account* or a *designated client fund account* (see CASS7.9.3G)."

Section 7.9.3G is part of the distribution rules, but contains a convenient explanation of the nature and purposes of those different types of account, and avoids the need to set out the detailed definitions of each of them, to be found in the Glossary. The explanation is as follows:

> "A *firm* can hold *client money* in either a *general client bank account*, a *designated client bank account* or a *designated client fund account*. A *firm* holds all *client money* in *general client bank accounts* for its *clients* as part of a common pool of *money* so that those particular *clients* do not have a claim against a specific sum in a specific account; they only have a claim to the *client money* in general. A *firm* holds *client money* in *designated client bank accounts* or *designated client fund accounts* for those *clients* that requested their *client money* to be part of a specific pool of *money*, so those particular *clients* do have a claim against a specific sum in a specific account; they do not have a claim to the *client money* in general unless a *primary pooling event* occurs. A *primary pooling event* triggers a notional pooling of all the *client money*, in every type of *client money* account, and the obligation to distribute it. If the *firm* becomes insolvent, and there is (for whatever reason) a *shortfall* in *money* held for a *client* compared with that *client's* entitlements, the available funds will be distributed in accordance with the *client money (MiFID business) distribution rules*."

102. CASS7.4.14 to 19 contains, mainly in the form of guidance, a concise description of the normal and alternative approaches for the segregation of client money. Since the alternative approach, adopted by LBIE, lies at the heart of a number of the fundamental issues, but since the bulk of CASS7 is applicable to both approaches, it is worth setting out those paragraphs in full:

> "Payment of client money into a client bank account
>
> 7.4.14G Two approaches that a *firm* can adopt in discharging its obligations under the *client money segregation requirements* are:
>
> (1) the 'normal approach' or
>
> (2) the 'alternative approach'.
>
> 7.4.15R A *firm* that does not adopt the normal approach must first send a written confirmation to the FSA from the *firm's* auditor that the *firm* has in place systems and controls which are adequate to enable it to operate another approach effectively.
>
> 7.4.16G The alternative approach would be appropriate for a *firm* that operates in a multi-product, multi-currency environment for which adopting the normal approach would be unduly burdensome and would not achieve the *client* protection objective. Under the alternative approach, *client money* is received into and paid out of a *firm's* own bank accounts; consequently the *firm* should have systems and controls that are capable of monitoring the *client money* flows so that the *firm* [can] comply with its obligations to perform reconciliations of records and accounts (see CASS 7.6.2R). A *firm* that adopts the alternative approach will segregate *client money* into a *client bank account[s]* on a daily basis, after having performed a reconciliation of records and accounts of the entitlement of each *client* for whom the *firm* holds *client money* with the records and accounts of the *client money* the *firm* holds in *client bank account* and *client transaction accounts* to determine what the *client money* requirement was at the close of the previous *business day*.
>
> 7.4.17G Under the normal approach, a *firm* that receives *client money* should either:
>
> (1) pay it promptly, and in any event no later than the next *business day* after receipt, into a *client bank account;* or
>
> (2) pay it out in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (see CASS 7.2.15 R).

7.4.18G Under the alternative approach, a *firm* that receives *client money* should:

(1) (a) pay any *money* to or on behalf of *clients* out of its own account; and

(b) perform a reconciliation of records and accounts required under CASS 7.6.2 R (Records and accounts), SYSC 4.1.1R and SYSC 6.1.1 R, adjust the balance held in its *client bank accounts* and then segregate the *money* in the *client bank account* until the calculation is re-performed on the next *business day*; or

(2) pay it out in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (see CASS 7.2.15 R).

7.4.19G A *firm* that adopts the alternative approach may:

(1) receive all *client money* into its own bank account;

(2) choose to operate the alternative approach for some types of business (for example, overseas equities transactions) and operate the normal approach for other types of business (for example, *contingent liability investments*) if the *firm* can demonstrate that its systems and controls are adequate (see CASS 7.4.15 R); and

(3) use an historic average to account for uncleared cheques (see paragraph 4 of CASS 7 Annex 1 G)."

103. For a full understanding of those paragraphs, the following points are to be noted:

i) The phrase "*MiFID segregation requirements*" is defined in the Glossary simply as CASS7.4.1R and CASS7.4.11R already quoted above.

ii) A convenient explanation of SYSC4.4.1R and SYSC6.1.1R (referred to in 7.4.18G(1)(b)) is to be found at CASS7.6.6G.

104. I shall have much to say in due course about the alternative approach, but it is worth noting from the outset the following points about the two approaches, and the contrast between them. First, both approaches are expressly designed to give effect to the segregation requirements in the MiFID implementing Directive. Secondly, the alternative approach is expressly designed not to facilitate the more profitable conduct by the firm of its own business, but to be a better means by which a firm operating in a multi-product, multi-currency environment can achieve the client protection objective: see 7.4.16G.

105. Thirdly, the normal approach does not expressly contemplate any payment of client money into the firm's own bank accounts (i.e. house accounts). By section 7.4.23G a firm operating the normal approach is required to pay mixed remittances from clients (i.e. that consist in part of client money and in part of other money) into client

account, where the non-client money element is promptly to be stripped out and paid out of client account (presumably, into house accounts). Fourthly, that paragraph, together with 7.4.20G make it clear that if for that or any other reason money which is not client money finds its way into client account, it is promptly to be removed (save for any minimum amount required to open, or keep open, the client account in question). It follows that CASS7 recognises as an objective that client accounts should contain only client money, but that from time to time they may briefly contain a mixture of client money and the firm's money.

106. Fifthly, a firm operating the alternative approach, which uses house bank accounts both for the receipt and payment of client money, necessarily holds one or more house accounts which contain a mixture of client money and the firm's own money. In practice, the house bank accounts used for the receipt and payment of client money under the alternative approach almost always contain such a mixture. The periodic reconciliations and segregations called for by CASS7.4.18G(1)(b) will inevitably be conducted at a time later than the point of reference to which they relate. Typically the point of reference is close of business, and the reconciliation and segregation are carried out usually during the morning of the following business day. During the period between the point of reference and the actual segregation (or de-segregation) of the amount of money required to bring the segregated accounts into accordance with the client money requirement, further client money will have been received from clients into, or paid to clients out of, the relevant house accounts used for that purpose. It necessarily follows that every reconciliation and segregation conducted under the alternative approach which leads to an increase in the amount segregated reflects the fact that, between the previous point of reference and the point of reference in question, there will have been client money mixed with the firm's money in house accounts.

107. Finally, and in sharp contrast with the normal approach, segregation under the alternative approach takes places on a net basis, rather than separately in relation to each amount of client money received. Thus, on a day when the outcome of a reconciliation and segregation process leads to the payment of a very small sum into or out of the segregated accounts, this may mask very large but self-cancelling directional payments between the firm and particular clients, into and out of the firm's house accounts. By self-cancelling, I mean that they are netted off in relation to the firm's overall requirement to segregate client money.

108. A striking feature of the guidance as to the alternative approach is that it is silent as to the consequences of mixing client money with the firm's own money in house accounts, in terms of the fiduciary obligations which may thereby be imposed on the firm.

109. It may be that the absence of any reference to such a fiduciary obligation is mitigated by CASS7.4.21R, which provides that:

> "If it is prudent to do so to ensure that *client money* is protected, a *firm* may pay into a *client bank account money* of its own, and that *money* will then become *client money* for the purposes of this chapter."

Two points arise from this paragraph. The first is that it would enable a firm to deal with the risks to clients occasioned from their money being mixed with the firm's money in house accounts by paying an amount of its own money into client account in an amount calculated or estimated to be larger than the net balance of client money likely to be found in the house accounts at any time. The amounts so allocated would constitute a prudential buffer against such risks.

110. The second point is that, albeit only to a very limited extent, LBIE did maintain such a prudential buffer in its client bank accounts, in relation to unapplied credits: see SAF paragraph 2.16.7. These were recent receipts into LBIE's house bank accounts about which, when conducting daily reconciliations, it was unable to ascertain whether or not they related to client money. This buffer therefore dealt with what LBIE calculated to be its typical margin of uncertainty when calculating the client money entitlement on any particular business day, but it did nothing to protect clients from the risks affecting client money mixed in house accounts in relation to receipts by LBIE of what it knew was client money. Put another way, it protected clients from the potential for under-segregation, but not against the risks which might arise between the firm's receipt of their client money into a mixed account, and the making of the segregation in relation to those receipts, on the following business day. By that time, in accordance with the Lehman Group's liquidity management processes, client money was routinely included as part of nightly sweeps of house account money to LBHI which, because LBHI was generally a creditor of LBIE, served to repay a debt rather than to create a substitute chose in action in LBIE's favour: see SAF paragraphs 2.21 to 27.

111. CASS7.4.21R could of course also be used by a firm to protect clients from the consequences of its accidental failure to segregate some part, or even all, of their money. Needless to say, LBIE made no such provision for the protection of its un-segregated clients, including (on the assumed facts) its affiliates in respect of what are claimed to be the billions of dollars which LBIE failed to segregate for them.

112. Finally under this section, CASS7.4.30R under the heading "Segregation in different currency" permits a firm to segregate client money in a different currency than that of receipt, but requires in such an event a daily adjustment of the amount segregated so as to equal the then value of the original currency amount, or the currency of the firm's contractual liability to its client, if different.

113. CASS7.5 makes brief and mainly uncontentious provision permitting firms to transfer client money to third parties in specified circumstances. It expressly authorises the system of client transaction accounts pursuant to which LBIE held client money in accounts with intermediate brokers and clearing houses for the funding and margining of exchange-traded positions entered into by LBIE on clients' behalf. An issue arose during the hearing as to whether this regime could legitimately be extended to transactions entered into on a principal to principal basis by the firm with the intermediate broker or clearing house, where conducted on a back to back rather than agency basis for the client. The resolution of that issue is affected by the language of CASS7.5, but I shall defer quoting from it until later.

114. CASS7.6 headed "Records, accounts and reconciliations", contains, as its title implies, the general provisions requiring firms to conduct internal and external reconciliations of client money balances. The first two paragraphs repeat the

corresponding provisions of Article 16(1)(a) and (b) of the MiFID implementing Directive. Paragraph 7.6.6G(3) incorporates Annex 1 by reference, described as "the *standard method of internal client money reconciliation"*, and refers to it as "a method of reconciliation of client money balances that the *FSA* believes should be one of the steps that a *firm* takes when carrying out internal reconciliations of *client money*."

115. CASS7.6.13R requires any reconciliation discrepancy, which identifies either a shortfall or excess in the segregated accounts as against a relevant client money entitlement, to be made good or, as the case may be, withdrawn from the relevant client bank account by close of business on the day on which the relevant reconciliation is performed. CASS7.6.14R makes similar provision in the event of a discrepancy thrown up by an external reconciliation. By CASS 7.6.16R a firm is required immediately to notify the FSA if it has failed to comply or is unable to comply in any material respect with its reconciliation obligations, and consequential obligations to make good shortfalls or deal with excesses.

116. CASS7.7 headed "Statutory trust" lies at the heart of the issues which I have to decide. It deserves being quoted in full:

> "7.7.1G Section 139(1) of the Act (Miscellaneous ancillary matters) provides that *rules* may make provision which result in *client* money being held by a *firm* on trust (England and Wales and Northern Ireland) or as agent (Scotland only). This section creates a fiduciary relationship between the *firm* and its *client* under which *client money* is in the legal ownership of the *firm* but remains in the beneficial ownership of the *client*. In the event of *failure* of the *firm*, costs relating to the distribution of *client money* may have to be borne by the trust.
>
> Requirement
>
> 7.7.2R A *firm* receives and holds *client money* as trustee (or in Scotland as agent) on the following terms:
>
> (1) for the purposes of and on the terms of the *client money rules* and the *client money (MiFID business) distribution rules;*
>
> (2) subject to (3), for the *clients* (other than *clients* which are *insurance undertakings* when acting as such with respect of *client money* received in the course of *insurance mediation activity* and that was opted in to this chapter) for whom that *money* is held, according to their respective interests in it;
>
> (3) after all valid claims in (2) have been met, for *clients* which are *insurance undertakings* with respect of *client money* received in the course of *insurance mediation activity* according to their respective interests in it;

> (4) on *failure* of the *firm*, for the payment of the costs properly attributable to the distribution of the *client money* in accordance with (2); and
>
> (5) after all valid claims and costs under (2) to (4) have been met, for the *firm* itself."

117. The following points require to be noted, in relation to CASS7.7.2R. First, there is an obvious misprint at the beginning of sub-paragraph (2). It became common ground during the hearing that the phrase "subject to (3)" means subject to (4).

118. Secondly, the reference to the "*client money rules*" in subparagraph (1) is, at least in this context, plainly a reference to the narrower definition of that phrase in the Glossary (i.e. to CASS7.1 to 7.8), rather than to the broader definition in CASS7.1.1R (i.e. the whole of CASS7) since, otherwise, the second part of sub-paragraph (1) would be otiose.

119. Thirdly, no one has suggested that the beneficial trust set out in sub-paragraph (2) springs to life only upon the failure of the firm even though, when the misprint is rectified, sub-paragraph (2) is subjected to subparagraph (4), which only applies on the firm's failure. The rival contentions are that the beneficial trusts arise upon receipt, or alternatively only upon segregation, of client money.

120. Subject to those uncontentious points, the meaning and intent of CASS7.7 and in particular its effect as incorporated into the distribution rules by CASS7.9.6R(2), has been the subject of intense and extended debate.

121. Nothing turns on section 8, relating to notification and acknowledgement of the statutory trust. It requires firms to notify their client account bankers, and their intermediate brokers, clearing houses and others in relation to client transaction accounts of the existence of the trust, and to obtain appropriate acknowledgements from them.

122. I turn finally to CASS7.9 headed "Client money distribution", which comprises the distribution rules which are the central subject matter of this application. It is built round the twin concepts of *primary pooling event* and *secondary pooling event*. A PPE occurs not only on the failure of the firm (see paragraph 7.9.4R(1)) but also on the happening of various forms of regulatory intervention (see paragraphs 7.9.4R(2) to (4) and 7.9.5R) which may, in theory, affect a solvent firm. *Failure* is defined in the Glossary as occurring upon the appointment of a liquidator, administrator, receiver or trustee in bankruptcy or equivalent insolvency event under foreign law.

123. As its heading implies, paragraph 7.9.2G conveniently summarises the purpose of the distribution rules as follows:

> "The *client money (MiFID business) distribution rules* seek to facilitate the timely return of *client money* to a *client* in the event of the *failure* of a *firm* or third party at which the *firm* holds *client money*."

Much debate has centred upon the inclusion of timeliness as part of that purpose.

124. I have already quoted in full the guidance in CASS7.9.3G as to the general effect of a PPE, at paragraph 101 above.

125. The rules as to what is to happen if a PPE occurs (in the remainder of this Judgment, a "PPE") are set out at paragraphs 7.9.6R, 7.9.7R, 7.9.9R and 7.9.11R. They are concise, and can conveniently be quoted in full:

> "7.9.6R If a *primary pooling event* occurs:
>
> (1) *client money* held in each *client* money account of the firm is treated as pooled; and
>
> (2) the firm must distribute that *client money* in accordance with CASS 7.7.2 R, so that each *client* receives a sum which is rateable to the *client money* entitlement calculated in accordance with CASS 7.9.7 R.
>
> 7.9.7R
>
> (1) When, in respect of a *client*, there is a positive individual *client* balance and a negative *client equity balance*, the credit must be offset against the debit reducing the individual *client* balance for that *client*.
>
> (2) When, in respect of a *client*, there is a negative individual *client* balance and a positive *client equity balance*, the credit must be offset against the debit reducing *client equity balance* for that *client*.
>
> …
>
> 7.9.9R Client money received after the failure of the firm
>
> *Client money* received by the *firm* after a *primary pooling event* must not be pooled with *client money* held in any *client money* account operated by the *firm* at the time of the *primary pooling event*. It must be placed in a *client bank account* that has been opened after that event and must be handled in accordance with the *client money rules*, and returned to the relevant *client* without delay, except to the extent that:
>
> > (1) it is *client money* relating to a transaction that has not settled at the time of the *primary pooling event*; or
> >
> > (2) it is *client money* relating to a *client*, for whom the *client money* entitlement, calculated in accordance with CASS 7.9.7 R, shows that *money* is due from the *client* to the *firm* at the time of the *primary pooling event*.
>
> …

7.9.11R If a *firm* receives a *mixed remittance* after a *primary pooling event*, it must:

(1) pay the full sum into the separate *client bank account* opened in accordance with CASS 7.9.9 R; and

(2) pay the *money* that is not *client money* out of that *client bank account* into a *firm's* own bank account within one *business day* of the *day* on which the *firm* would normally expect the remittance to be cleared."

126. Part of those provisions, in particular paragraphs 7.9.9(1) and 7.9.11R are relatively straightforward, clear and uncontentious. By contrast, every aspect of paragraphs 7.9.6R and 7.9.7R has been subjected to prolonged and intense debate, centring on the fundamental issues:

i) precisely what client money is to be pooled;

ii) whether a client's entitlement to share depends upon what was, or upon what ought to have been, segregated for that client; and

iii) by reference to what date are the qualifying clients' shares to be calculated or valued.

Since the resolution of those issues occupies most of the remainder of this judgment, I shall say no more about them at this stage.

127. The PPE distribution rules which I have set out are augmented by further guidance, and in particular paragraph 7.9.8G, which states:

"A *client's* main claim is for the return of *client money* held in a *client bank account*. A *client* may be able to claim for any *shortfall* against *money* held in a *firm's* own account. For that claim, the *client* will be an unsecured creditor of the *firm*."

This was the guidance which, on behalf of the FSA which published it, Mr Knowles roundly declared to be wrong. It was no mere typographical error, since the FSA included it in the revised version of the distribution rules which came into force on 1st January 2009, after LBIE's failure. Upon my inquiry, Mr Knowles informed me that the FSA intended to correct it as soon as practicable.

128. The remainder of section 9 deals with secondary pooling events, which, as explained in paragraph 7.9.14R, occur on the failure of a third party to which client money held by the firm has been transferred. Typically, such secondary pooling events occur upon failure of a bank at which a firm has opened a client money bank account, but they can also occur upon the failure of an intermediate broker or other third party with which the firm holds a client transaction account. In the present case, a secondary pooling event occurred upon the failure of Bankhaus, shortly after the firm's own failure.

129. CASS7.9.13R provides that:

> "If both a *primary pooling event* and a *secondary pooling event* occur, the provisions of this section relating to a *primary pooling event* apply."

Since in the present case, LBIE failed before Bankhaus, it was common ground that the provisions of section 9 relating to secondary pooling events are of no direct application, although their terms were to a limited extent relied upon as relevant to the interpretation of other parts of CASS7.

130. The general effect of the secondary pooling event regime is complicated. Broadly speaking, (and the detail does not matter), client money in certain types of segregated account held otherwise than at the failed bank or other third party is protected from pooling, so that the clients entitled to that money do not share in the misfortune constituted by that failure. Specific rules are made by reference to different types of client account held with the failed third party, and there are similar provisions to those in paragraph 7.9.9R in relation to client money received by the firm after the third party's failure.

131. The provision in the secondary pooling event regime upon which reliance has been placed for the purposes of construction is paragraph 7.9.21R, which reads as follows:

> "7.9.21R Money held in each *general client bank account* and *client transaction account* of the *firm* must be treated as pooled and:
>
> (1) any *shortfall* in *client money* held, or which should have been held, in *general client bank accounts* and *client transaction accounts*, that has arisen as a result of the *failure* of the bank, must be borne by all the *clients* whose *client money* is held in either a *general client bank account* or *client transaction account* of the *firm*, rateably in accordance with their entitlements;
>
> (2) a new *client money* entitlement must be calculated for each *client* by the *firm*, to reflect the requirements in (1), and the *firm's* records must be amended to reflect the reduced *client money* entitlement;
>
> (3) the *firm* must make and retain a record of each *client's* share of the *client money shortfall* at the failed bank until the *client* is repaid; and
>
> (4) the *firm* must use the new *client money* entitlements, calculated in accordance with (2), for the purposes of reconciliations pursuant to CASS 7.6.2 R (Records and accounts), SYSC 4.1.1R (General organisational requirements) and SYSC 6.1.1 R (Compliance) (as described in CASS 7.6.6 G)."

132. This relates to the failure of a bank at which the firm holds one or more relevant client accounts. Reliance is placed upon the fact that paragraph 7.9.21(1) requires a re-

calculation of the client money entitlements not merely of clients whose money was held at the relevant bank, but of clients whose money should have been held there, the suggestion being that this supports a claims based rather than contribution based entitlement theory.

133. Unfortunately, such effect as that provision might have had upon the interpretation of the distribution rules relating to a primary pooling event is largely cancelled out by paragraph 7.9.22G which, in seeking to explain paragraph 7.9.21(1) states:

> "The term 'which should have been held' is a reference to the *failed* bank's *failure* to hold the *client money* at the time of the pooling event."

The implication is that this provision was not intended to relate to any failure by the firm itself to identify and therefore segregate client money.

134. I cannot leave this necessarily long exegesis of CASS7 without some reference to Annex 1, which contains detailed guidance as to the conduct of internal client money reconciliations, and about parts of which there was yet further intense debate.

135. The main relevance of Annex 1 is that it sheds light on the meaning of the phrases "*client money* entitlement" and "individual *client* balance" in CASS7.9.6R, 7.9.7R and 7.9.9R and sheds invaluable light on the otherwise baffling meaning and purpose of CASS7.9.7R taken as a whole.

136. I have concluded that no useful purpose would be served by setting out the relevant parts of Annex 1 in full. It is relatively complex and introduces a host of new defined words and phrases. I shall therefore refer to the relevant parts of Annex 1 only where necessary, later in this judgment.

THE MAIN ISSUES

1. – <u>Does the Statutory Trust created by CASS 7 take effect upon receipt, or only upon the segregation, of client money?</u>

2. – <u>If upon receipt, what duties or restrictions are imposed by the rules, or by the general law, upon the use that the firm can make of client money while mixed with its own money pending segregation under the alternative approach?</u>

137. These two issues are inseparable, not least because the proponents of the view that the statutory trust takes effect only upon segregation rely heavily upon the absence of any express restrictions in the rules upon a firm's use of client money while mixed with its own money pending segregation under the alternative approach. Neither issue is raised directly by the questions posed to the court by this application, but they underlie the analysis of a large number of them. Furthermore, since the analysis of the effect of the distribution rules depends critically upon a precise understanding of the proprietary interests of clients in money held by the firm both before, at the point of, and following, the PPE, a firm conclusion as to the point at which the statutory trust bites is an inescapable first stage in that process.

138. There is much to be said for the proposition, advanced by Mr Milligan in reply, that the question when the statutory trust attaches to client money is really a short point of construction, unambiguously answered by the opening words of CASS7.7.2R:

> "A *firm* receives and holds *client money* as trustee…"

Correcting the slight abbreviation, he said that it means a firm receives client money as trustee and holds client money as trustee.

139. Nonetheless, bearing in mind that apparently unambiguous English legislation implementing EU obligations may turn out to mean something very different from the clear meaning of the words, and out of respect to the powerful contrary arguments advanced both by Mr Peacock and Mr Snowden, the first question cannot be so easily disposed of. I shall first briefly summarise the arguments in favour of the case that the statutory trust bites only upon segregation, before expressing my own conclusions on the question.

140. The 'trust only upon segregation' case proceeded upon the following main lines:

i) The English antecedent to the statutory trust in CASS7, which dates back to the mid-1980s, was recommended and adopted in terms which assumed that the trust would attach to client money only upon segregation.

ii) The essential thrust of the MiFID Directives (and in particular the MiFID implementing Directive) is that the protection of clients' rights in relation to client money is to be achieved by segregation, rather than by the prior imposition of a trust creating a proprietary interest. If CASS7 were construed so as to give rise to a trust earlier than upon segregation, it would amount to illegitimate gold plating.

iii) Neither Article 13(8) of MiFID, nor CASS7.3.1R (which repeats it almost verbatim) impose an absolute ban upon a firm's use of client money for its own purposes, but only a requirement to make adequate arrangements to safeguard the client's rights in that respect. Furthermore, the alternative approach set out in CASS7.4.18Gff leaves the firm completely free to use client money mixed in its house accounts for its own purposes, and in particular leaves the firm free to use substitute money to achieve segregation thereafter.

iv) Accordingly, read in its context, the phrase in CASS7.7.2R "receives <u>and</u> holds" encapsulates the requirements for receipt, identification and segregation as preconditions to the arising of the statutory trust, in contrast for example to CASS7.2.1R which, in defining client money, uses the different phrase "receives from <u>or</u> holds" (my underlining).

v) All the rival theories which seek to justify the recognition of a statutory trust upon receipt of client money are irreconcilable with English property law, specifically trust law. They either involve the implication of restrictions upon the use which a firm can make of its house accounts which are absent from the rules and in any event unworkable, or, if they acknowledge that the house accounts may be used without restriction, are simply irreconcilable with the essential nature of a trust.

vi) If CASS7 did create a trust from receipt, regardless of subsequent segregation, then if CASS7.9.6R(1) is interpreted as applying only to client money held in segregated accounts (which is itself the subject of dispute), then the distribution rules contain a black hole or lacuna, since they leave undistributed any client money in house accounts to which clients can establish a proprietary claim.

141. In my judgment, CASS7.7.2R, read in its full context, clearly imposes a statutory trust upon the receipt of client money by a firm. My reasons (which largely accord with the submissions of the majority of the parties, including both the FSA and the Administrators in reply) now follow.

142. The starting point is to appreciate the various ways in which a firm may become obliged to segregate client money. The first is upon direct receipt from the client. The second is upon receipt from a third party for, on behalf of, or to the credit of, a client. The third, which does not involve receipt by the firm at all, arises where a contractual monetary obligation of the firm obliges it to satisfy a client money entitlement by appropriating money of its own to that entitlement, and promptly segregating it. This may occur where an OTC transaction between the client and the firm is cash-settled at a profit to the client. The firm must either pay that profit direct to the client, or recognise a client money entitlement in the same amount and segregate it. The same obligation occurs in relation to a manufactured dividend: see SAF 2.19. Another example expressly contemplated by the guidance is the commission rebate referred to in CASS7.2.12G-13G. I have referred at paragraph 94 above to the rather awkward way in which what is in reality a client money obligation or entitlement is treated in paragraph 7.2.13G(1) as if it were client money.

143. The obligation of a firm to appropriate property of its own towards the satisfaction of a client money entitlement (or, which is the same thing, to meet a client money obligation) is the subject of detailed analysis by Sir Andrew Park in <u>Global Trader (No1)</u> at paragraphs 73 to 76 (in relation to CASS4, the predecessor of CASS7) and paragraphs 83 to 85 (in relation to CASS7). His analysis, with which I respectfully agree, was that where, in circumstances otherwise than by reason of a receipt, a firm becomes liable to appropriate property of its own to meet a client money entitlement, for example upon the closing of an OTC position profitable to the client, the firm's obligation rested purely in contract until a sum of its own money was actually appropriated to meet that obligation. Usually, such appropriation took place by means of segregation. Pending appropriation of a sum with which to meet that client money obligation, there is simply no identifiable property to which a trust can rationally be attached.

144. The position is of course otherwise in relation to a receipt of client money, whether directly from the client, or from a third party on the client's behalf. In that case, there is from the moment of receipt by the firm, property to which a trust can attach, if that is the meaning and intent of the rules. Since the purpose of the statutory trust is to protect client money from misuse, it seems very counter-intuitive to think in terms of client money (originally the client's beneficial property) ceasing to be the client's

property upon receipt by the firm, and it (or substitute money) then becoming the client's property again upon segregation shortly thereafter.

145. Under the normal approach to segregation, it will usually be the client's money which is segregated promptly upon receipt: see CASS7.4.17G(1). Under the alternative approach, the firm may (and usually will) segregate an equivalent amount of its own (or mixed) money at the point of next segregation. But it makes much more sense to think of the client's proprietary interest in his money being transferred to the substitute money simultaneously with the segregation of that money, rather than there being a time-lag between receipt and segregation of anything up to a business day (which may include a week-end and any Bank Holiday), during which the client has no proprietary entitlement at all.

146. In my judgment, the fact that client money may come to be held (and segregated) by a firm otherwise than purely because of a prior receipt explains why the draftsman used the phrase "receives and holds" in CASS7.7.2R as a comprehensive formula for the attaching of a statutory trust to client money as soon as it is identifiable in the firm's hands. Once it is identifiable by receipt, it is subject to the trust. Where money becomes identifiable as client money only by being appropriated out of the firm's resources to meet a client money obligation, it becomes subject to the trust upon the moment of appropriation, because it is then for the first time "held" as client money. Prior to that appropriation it was the firm's money, not client money. Usually, although it does not strictly matter, that appropriation will be achieved by segregation, that is by the transfer of the appropriate sum from the firm's own monetary resources to the appropriate segregated account.

147. The concept that money may become client money otherwise than merely by receipt is also implicit in the phrase "received from or holds for" in CASS7.2.1R. Contrary to Mr Peacock's submission I consider that there is no magic in the use of "or" in that paragraph and "and" in paragraph 7.7.2R.

148. I consider that an interpretation of this provision in CASS7 by reference to the MiFID Directives is strongly supportive of the case that a trust of client money received by a firm arises upon receipt, rather than only upon segregation. Quite simply, that analysis better serves the MiFID objectives of protecting clients' rights in relation to their funds, both from use of those funds for the firm's own purposes, and from the consequences of the firm's insolvency. As Professor Gower pointed out as long ago as January 1984 in his Review of Investor Protection (Part I) Cmnd 9125, the mere segregation of client money from the firm's money does not of itself protect the clients' rights from the firm's insolvency, unless accompanied by a trust. The imposition of a statutory trust is not therefore in any sense gold plating. It is precisely that kind of additional requirement contemplated by Article 16(2) of the MiFID implementing Directive necessary to make the requirements set out in Article 16(1) (which include but are not limited to segregation) effective in the context of the domestic law of a particular Member State, in this case the law of part of the United Kingdom (i.e. excluding Scotland, where no trust is or could be imposed). By the same token, protection by the identification by appropriate records and accounts of client money, as separate from the firm's own money, as required by Article 16(1)(a) of the MiFID implementing Directive, is equally ineffective in English law unless also accompanied by the imposition of a trust. By contrast, a trust of identifiable client money is effective to provide the protection required by the MiFID Directives,

albeit that the protection is by no means complete unless and until the identifiable client money has also been segregated. In particular, if it is identifiable merely as part of a mixed account (mixed that is with the firm's own money) then it is subject to a variety of risks of the type which have led the English courts over more than two centuries to develop the rule that, in the absence of agreement, a trustee must not mix trust money with his own money.

149. It would have been a formidable objection to the recognition of a statutory trust in advance of segregation if I had concluded that the effect of CASS7 was to create a regime that left a firm using the alternative approach completely at liberty to use client money mixed with its own money in house accounts for its own purposes. In Paragon plc v. DB Thakerar & Co [1999] 1 All ER 400 at 416, Millett LJ said this, commenting on Nelson v. Rye [1996] 1 WLR 1378:

> "Whether he was in fact a trustee of the money may be open to doubt. Unless I have misunderstood the facts or they were very unusual it would appear that the defendant was entitled to pay receipts into his own account, mix them with his own money, use them for his own cash flow, deduct his own commission, and account for the balance to the plaintiff only at the end of the year. It is fundamental to the existence of a trust that the trustee is bound to keep the trust property separate from his own and apply it exclusively for the benefit of his beneficiary. Any right on the part of the defendant to mix the money which he received with his own and use it for his own cash flow would be inconsistent with the existence of a trust."

See also Henry v. Hammond [1913] 2 KB 515 at 521.

150. I consider however that this submission puts the cart before the horse. While the alternative approach sanctioned by CASS7 undoubtedly permits a firm to mix client money with its own money in house accounts, it by no means follows that the absence of any express provision to the contrary in CASS7 amounts to an implicit authority to the firm to use that mixed fund entirely for its own purposes and without restraint, during the usually short period between a relevant receipt and a corresponding payment into a segregated client account at the point of next reconciliation. CASS 7.3.1R and 7.3.2R contain rules which, in unqualified terms, require firms, when holding client money, to make adequate arrangements to safeguard the client's rights, to prevent the use of client money for the firm's own account, and to minimise the risk of loss of diminution of client money or rights in connection with it, as the result of (*inter alia*) misuse.

151. Where client money is, under the alternative approach, mixed with the firm's own money in one or more house accounts, both those paragraphs of CASS7 and (if the better view is that if the client money is held on trust from receipt) the general law, do in my judgment impose upon firms an obligation to deal with house accounts in such a way that clients' rights in relation to client money in those accounts are not put at risk, and the client money not used for the firm's own purposes, pending segregation.

152. It was submitted that it would be impossible for firms to devise any system for protection of clients' rights in those circumstances, both because of the practical

impossibility for a large firm to know from moment to moment between successive points of segregation the precise amount of client money in its house accounts, and because the inhibitions which that would place upon the firm's business use of its own funds would be uncommercial.

153. I disagree. It seems to me that there are at least two methods whereby a firm can protect client money mixed in its house accounts between successive points of segregation under the alternative approach. The first takes advantage of the general rule that where a trustee holds trust money and money of his own in a mixed account, any payment out of that account otherwise than for a purpose authorised by the trust is deemed to be a payment of his own money rather than of the trust money. It follows that by maintaining a minimum balance on house accounts used for the receipt of trust money under the alternative approach sufficient to ensure that there is never less in a particular house account than the amount of the client money contribution to it, between any two points of segregation, a firm will substantially protect the client money, and the clients' rights in relation to it, from misuse. It would also be necessary for the firm to avoid subjecting those house accounts used for the receipt of client money to any form of charge or other security, or to any group liquidity management arrangements of the type used by the Lehman Brothers group.

154. The objection that a firm would never know what size of minimum balance to maintain, due to the impossibility of knowing from moment to moment the amount of the client money contribution to that house account seems to me to be answered by LBIE's own practice in quantifying the segregated buffer in respect of unapplied credits: see SAF 2.16.7. Since a firm's obligation to maintain records distinguishing between client and house monies must be sufficient for it to know, retrospectively, the amounts of client money in house accounts over time, I can see no reason why historical statistical information could not be used by a firm for the purpose of quantifying the amount of a prudential buffer of that type.

155. An alternative form of protection, (using the same historical calculation to provide a prudent quantification of the amount required) could be used to establish a prudent buffer in a segregated client account, pursuant to CASS7.4.21R, thereby leaving the firm completely free to use its house accounts for its own purposes, secure in the knowledge that there was also an additional amount in the segregated client accounts, in excess of the amount of client money mixed in house accounts between successive points of segregation.

156. It is not for the court to specify the precise method whereby a firm using the alternative approach should make adequate arrangements to safeguard the clients' rights in relation to client money mixed in house accounts. It is sufficient for the court to conclude, as I do, that the obligation exists, leaving firms, their auditors and the FSA to decide on a case by case basis the adequacy of such arrangements as are proposed or implemented.

157. I acknowledge the force of the 'black hole' submission made by the proponents of the 'trust only upon segregation' case, not least because (for reasons to which I will come in due course) I have concluded that CASS7.9.6R(1) is to be interpreted as applying only to client money held in segregated accounts. Subject to the top up issue, the consequence is that the distribution rules will fail to deal with client money held on trust in mixed house accounts, even if identifiable as at the PPE.

158. The black hole will apply in particular to client money paid by a firm adopting the alternative approach into house accounts between the PLS and the PPE. At the very least it produces an untidiness, by contrast with an interpretation pursuant to which all trust money passes back to clients under the *pari passu* scheme enshrined in the distribution rules, while the firm's own money passes to its creditors under the *pari passu* statutory scheme triggered by its insolvency. Proponents of the 'trust only upon segregation' case ask with rhetorical force: what is the point of imposing a statutory trust upon client money prior to segregation, if it is not then caught and distributed by the distribution rules upon the happening of the very event against which the statutory trust was meant to provide protection?

159. There is I think no completely satisfying answer to this black hole point, at least at an intellectual level. As will appear, there is a satisfying answer at a practical level, namely good reason for avoiding encumbering the scheme contemplated by the distribution rules with the delays, complexity, expense and potential for litigation of a search for identifiable trust property in a firm's house accounts, for the purpose of identifying and then distributing the CMP.

160. In the end, it remains a point of substance against the interpretation of CASS7 as imposing a statutory trust from the point of receipt of client money. But it comes nowhere near outweighing the reasons pointing to an affirmative conclusion on this issue. Leaving aside considerations of practicability (to which I return at length later in this judgment) there are two further reasons why this point is only of limited weight.

161. The first is that there can only be one conclusion on this issue, applicable as much to firms which operate the normal approach, as it is to firms which operate the alternative approach. Under the normal approach, the reasonable addressee (see Attorney General for Belize) would not expect to find any, or at least any significant, amount of client money in the firm's house accounts as at the PPE, because the general rule under the normal approach is that client money should be paid direct to a segregated account, even if it forms part of a mixed payment by the client: see CASS7.4.17G(1) and 7.4.23G. To allow an untidiness arising from client money payments by a firm using the alternative approach into house account during the short period between the PLS and the PPE to dictate the interpretation of a fundamental provision governing the moment of incidence of the statutory trust would in my judgment be to allow the tail to wag the dog.

162. Secondly, client money payments into house accounts under the alternative approach between the PLS and the PPE will only cause a practical difficulty if and to the extent that they exceed client money payments out of house accounts during the same period. This is because, at each point of segregation, it is only the net amount which is to be paid into or out of the segregated accounts. In the case of LBIE, payments out exceeded payments in between the PLS and the PPE by some US$255 million (so I was informed by the Administrators, although this figure does not appear in the SAF). It is not generally unreasonable to assume a net outflow of client funds during the last working day before a firm's failure. It follows that, even in relation to firms using the alternative approach, the black hole point may be of limited significance.

163. Finally, to the extent that there is identifiable client money in a firm's house account as at the PPE, it will not be irrecoverable, because it will be trust property in respect

of which there are beneficiaries to claim it, using the equitable remedies available under the general law.

164. My approach to the interpretation of CASS7 on this issue has been based mainly upon an assumption that a firm complies with its segregation obligations rather than, as in LBIE's case, fails spectacularly to comply over a long period. A long term systematic failure to segregate client money may, of course, lead to much larger accumulations of trust property in mixed house accounts. Where that failure is inadvertent rather than deliberate (and therefore fraudulent) it is likely to be accompanied by a similar failure to take steps to preserve the value of clients' rights in that client money, whether by the maintenance of a minimum balance or the setting up of a prudential segregated buffer. It follows that it is *prima facie* unlikely that the client money deposited in house account over a long period in respect of clients which the firm failed to recognise as being entitled to client money protection will still be identifiable as such when the firm fails.

165. The one submission of the proponents of the 'trust only upon segregation' case with which I have not thus far dealt in the course of my reasons for reaching the opposite conclusion is that based upon the English historical antecedents to CASS7. In my judgment it is wrong in principle to construe CASS7 (a new code designed to implement the MiFID Directives) by reference to its purely English predecessors. Even if it had been permissible to do so, I was not persuaded that earlier versions of the client money rules did impose a trust only upon segregation, although this conclusion is not a central or necessary part of my reasoning. I notice in passing that in <u>Global Trader,</u> which was in part a case about CASS4 (the predecessor of CASS7), Sir Andrew Park appears to have encountered no difficulty in concluding that CASS4 imposed a statutory trust from receipt: see <u>Global Trader (No 1)</u> at paragraphs 55 to 60.

3. – <u>Does the CMP include all identifiable client money held by LBIE as at the PPE, whether or not actually segregated? If not segregated, how is it to be identified?</u>

166. The starting point for the analysis of this issue is the provision in CASS7.9.6R(1) that, if a PPE occurs:

> "*Client money* held in each *client money* account of the *firm* is treated as pooled…"

The (perhaps old fashioned) principle of construction that words are there for a purpose suggests that the phraseology used was designed to achieve at least the following two purposes. The first is that it was not the intention of the draftsman to capture all client money held by the firm, but only client money held in "each client money account of the firm". Secondly, it was not the intention to capture all money held in each client money account of the firm, but only client money held in such accounts.

167. Most of the parties to the application asserted, or were content to assume, that the expression "each client money account of the firm" was intended to identify the segregated accounts, namely the general client bank accounts, designated client bank accounts and designated fund accounts referred to in the first sentence of CASS7.9.3G, together with any relevant client transaction accounts, and any other

segregated account held by a third party as a repository for the client money of LBIE's clients.

168. Nonetheless, Mr Jarvis and Mr Tozzi sought to persuade me to a broader view. Mr Jarvis's submission was that any account into which client money had ever been paid, otherwise than purely by mistake, was a "client money account of the firm". Mr Tozzi submitted, slightly more narrowly, that the expression included every account of the firm in which client money was to be found as at the PPE. They both argued that the phrase "each *client money* account of the *firm*" was, deliberately, not a defined term, and was therefore apt for a broader interpretation if that would serve the purposes of the MiFID Directives.

169. In order to seek to demonstrate that those purposes would not be served by confining that expression to segregated accounts, both Mr Jarvis and Mr Tozzi sought to maximise the amount of client money capable of being identified in non-segregated (i.e. house) accounts. So did Mr Flint and Mr Knowles, for the separate purpose of seeking to persuade me that CASS7 permitted top up of the CMP from identifiable client money held by the firm outside its segregated accounts. While they were, therefore, both prepared to accept that CASS7.9.6(1) identified only the firm's segregated accounts, it is convenient to deal at this stage with all the rival submissions as to the means of identification of client money held outside a firm's segregated accounts.

170. Although some of the parties' positions shifted a little during argument, I was presented in substance with three main theories. The first, from Mr Flint, proceeded on the basis that a firm holds client money from receipt, but is, under the alternative approach, free to use its house accounts without restraint. The only way in which the MiFID purposes could be achieved, he submitted, was by recognising a species of floating trust over all the firm's house accounts, non-client transaction accounts and other receivables, which would crystallise as at the PPE so as to confer upon all those with client money claims the benefit of an equitable charge over those assets, having priority to LBIE's unsecured creditors. This submission was heavily based upon <u>Re Bond Worth Ltd</u> [1980] Ch 228, but sought to escape from the fatal defect of the charge in that case, constituted by non-registration, by the ingenious argument that the trust in the present case is created by statute, rather than by the company.

171. The second theory, ultimately supported by Mr Jarvis, Mr Tozzi and Mr Knowles, was founded upon the twin assumptions that the statutory trust applied from receipt, and that the combination of CASS7 and the general law imposed restrictions on the firm's use of client money mixed in house accounts, such that any use of client money for the firm's own purposes constituted a breach of trust. In such circumstances, the achievement of the MiFID purposes entitled the court to consolidate all those accounts of the firm into which client money had ever been paid or transferred, to treat those consolidated accounts as a single mixed fund, and to permit the clients with client money claims to identify their property in that fund, and to recover it by the imposition of an equitable charge, of the type referred to by Lord Templeman in <u>Space Investments Ltd v. Canadian Imperial Bank of Commerce Trust Company (Bahamas) Ltd</u> [1986] 1 WLR 1072, at 1074, and by Lord Millett in <u>Foskett v. McKeown</u> [2001] 1 AC 102, at 130 to 132.

172. The third theory, advocated by Mr Zacaroli, Mr Peacock and, in closing, by Mr Milligan, was that the essential prerequisite for the pursuit of any proprietary claim to trust money outside the firm's segregated accounts was that the claimant had to be able to identify its property by the conventional principles applicable to tracing and following, the onus being on the claimant, on an account by account basis. The sheet anchor for this submission was the following well known passage in Re Diplock [1948] Ch 465, at 521:

> "The equitable remedies presuppose the continued existence of the money either as a separate fund or as part of a mixed fund or as latent in property acquired by means of such a fund. If, on the facts of any individual case, such continued existence is not established, equity is as helpless as the common law itself."

It would therefore be fatal to any such proprietary claim if the house account in question had gone into overdraft or been reduced to zero. Proprietary claims in relation to mixed accounts (mixed that is between trust property and the trustee's own property) were therefore necessarily limited to the minimum balance on that account between the date of deposit of client money and the date of claim.

173. The proponents of theories one and two all took as their starting point the MiFID purpose of achieving a high degree of investor protection, in safeguarding client money, and clients' rights in relation to it. It was suggested that this required the court to construct a more modern and client-friendly basis for the identification and recovery of their property among assets vested in LBIE outside its segregated accounts, in circumstances where, as here, the firm has spectacularly failed to segregate very large amounts of client money, over a long period of time. It is in that context no coincidence that three of the four proponents of those theories were, or represented, un-segregated clients. The fourth, the FSA, sought to make good the spectacular failure to protect those clients' claims by LBIE, its auditors and regulators, by what Mr Knowles acknowledged was an innovative approach to the law.

174. In my judgment neither the MiFID Directives nor CASS7 impose any such obligation on the court, in favour of clients of a firm whose protection has been undermined by the firm's failure to implement or comply with the obligations and organisational requirements thereby imposed. I have already given my reasons for this conclusion, at paragraphs 65 to 69 above.

175. There is in any event good reason for caution before embarking upon an extension of the settled principles of tracing, where the corollary is to cut down the claims against an insolvent firm of its unsecured creditors. In Re B A Peters (in Administration) [2008] EWCA Civ 1604 Lord Neuberger said this, at paragraph 21:

> "In my view, the court should not be too ready to extend the circumstances in which proprietary or other equitable claims can be made in insolvent situations, bearing in mind the consequences to unsecured creditors. To raise those in the commercial world, it must sometimes seem almost a matter of happenstance as to whether or not a particular creditor, with no formal security, has a proprietary or equitable claim. However

> the fact is that every time such a claim is held to exist in the case of an insolvent debtor, the consequence is that one commercial creditor gets paid in full to the detriment of all the other commercial creditors, who also have no formal security, but are found to have no proprietary claim."

176. It is convenient to deal first with Mr Flint's floating trust. Ingenious though it is, I consider that it faces insuperable obstacles. The first is that I have already concluded, contrary to Mr Flint's starting point, that both CASS7 and the general law did impose restrictions upon LBIE with regard to what it could do with client money while mixed in house accounts with the firm's own property. A floating charge is of course essentially based upon the notion that it attaches to assets which, pending crystallisation, the chargor is free to use for the purposes of its business: see Re Yorkshire Woolcombers Association Ltd [1903] 2 Ch 284 at 295. It follows that, on the view which I have taken of the effect of the statutory trust, the essential substratum for the recognition of a floating trust or charge is missing.

177. In case I am wrong about that, there are a number of further reasons why, in my judgment, the floating trust or charge theory cannot succeed. First, notwithstanding Slade J's references to the charge under review in Re Bond Worth (*supra*) as "a trust under which Monsanto had a charge in equity" (at page 247) and "a declaration of trust by Bond Worth in respect of the relevant assets by way of equitable charge" (at page 266), there is a fundamental difference between a trust and a charge. A trust preserves the beneficiary's ownership of property vested in the trustee, whereas a charge provides security to a creditor over the chargor's own beneficial property: see for example the analysis of Millett J in Re MC Bacon Ltd [1990] BCC 78 at 92E to F; and Re LBIE [2009] EWCA Civ 1161, per Patten LJ at paragraphs 59 to 60.

178. In my judgment Mr Flint's creation should be recognised for what it is, namely a charge and not a trust. In so concluding I do not ignore the fact that equity may impose a form of charge over a mixed fund as a way of appropriating to the beneficiary, as against the trustee, assets in a fund in the ownership of which he has identified a shared beneficial interest. Nonetheless there is all the difference between a trust and a charge, in their inception.

179. While it is conceivable that the draftsman of CASS7 could have mis-described as a trust that which was intended to be created as a charge, it is hardly a promising start. But the difficulties do not end there. The particular legislative authority of the FSA in this context expressly includes the power to create a trust, in section 139 of the FSMA, but not a charge. Furthermore, the efficacy of a charge depends upon a clear identification of the property of the chargor which is subjected to it. No such identification is to be found in CASS7. Once an attempt is made to sidestep the settled basis upon which the court recognises a proprietary interest by tracing and following, the identification of the assets to which the suggested charge is to apply becomes little short of arbitrary.

180. Even if CASS7 had purported to provide for a floating charge, I am by no means satisfied that it would properly be regarded as anything other than a charge created by the company for the purposes of the registration requirement under the Companies Acts. In my judgment, the better view is that, subject to all the other difficulties, a firm regulated by CASS7 would itself create such a floating charge by accepting

client money into its house accounts, rather than by paying it direct into a segregated account, as contemplated by the normal approach.

181. Finally, if it were an unregisterable charge, there are to my mind insuperable difficulties as to priority between such a charge and other securities created over the firm's assets. In the absence of a single chargee (such as a debenture holder trustee) the charge would presumably inure for a constantly changing stream of clients, on an almost daily basis while the firm continued in business.

182. I turn therefore to address the competition between the second and third theories for the identification of proprietary interests of un-segregated clients in the un-segregated accounts of the firm.

183. The high water mark in Mr Jarvis's submissions (from which, to be fair, the tide receded a little in his reply) was a submission that whenever a trustee misapplies trust property in his own favour, he thereby makes himself a constructive trustee of all his assets, for the wronged beneficiary. As the argument developed, particularly during replies, he, Mr Tozzi and Mr Knowles progressively refined the submission so as to confine it to those accounts of the firm which had ever been used for the receipt of client money, or into which the firm could not demonstrate that no client money had ever been paid. In particular, they submitted that if the firm applies a liquidity management process across a whole range of its house accounts (as did LBIE) then it would be wrong to draw any distinction between house accounts into which client money was actually paid, and other house accounts subjected to the same process. All of them should be consolidated, so the argument ran, and the firm's un-segregated clients (i.e. those whose money should have been but was not segregated) recognised as beneficial co-owners of that fund, with a right to have a sufficient part of that fund appropriated to their entitlement, by way of an equitable charge of the Foskett v. McKeown type.

184. The high water mark of the authorities in this area undoubtedly consists of Space Investments (*supra*) in which, in relation to the large scale use of client money by a trustee bank, Lord Templeman said (*obiter*) that if the use was unauthorised, then the clients could indeed pursue proprietary claims into a fund constituted by the whole of the bank's assets. The *ratio* of the case was that, since the trustee bank had applied the trust fund by way of deposit with itself pursuant to a power to that effect contained in the trust instrument, there had been no misappropriation, so that the beneficiary's claim failed. It is however Lord Templeman's *dictum* as to the consequence if the deposit had been a breach of trust that commands attention for present purposes. It appears at page 1074 B to H. The *dictum* may be summarised as follows:

i) The trustee bank used the deposits for its general purposes so that it was impossible for the wronged beneficiaries to trace the money misappropriated from their trust to any particular assets of the bank.

ii) Accordingly the beneficiaries could trace their property into the whole of the bank's assets, and recover it by the exercise of an equitable charge.

iii) If the bank goes into liquidation, that charge will take priority over the claims of the bank's other customers and over all claims of other unsecured creditors.

iv) That priority causes no injustice to the unsecured creditors, who by contrast with the beneficiaries, voluntarily accept the risk of the bank's insolvency.

v) This is an equitable application of the rule in Re Hallett's Estate (1880) 13 Ch.D. 696, at 719, whereby equity protects beneficiaries against breaches of trust.

185. That *dictum* in Space Investments has not passed without a quantity of mainly adverse comment. It is best encapsulated in paragraph 41-112 of Lewin on Trusts (18th ed), the thrust of which is that the supposed ability of the beneficiary to trace his property into the general assets of a defaulting bank trustee is inconsistent with Re Diplock (*supra*), in particular with the passage in that decision which I have quoted at paragraph 172 above.

186. Some of this criticism was acknowledged in the later decision of the Privy Council in Re Goldcorp Exchange Ltd [1995] 1 AC 74, at 109-110, a judgment in which Lord Templeman participated, in which it was said that the law relating to the creation and tracing of equitable proprietary interests was still in a state of development.

187. Two months later, both Space Investments and Goldcorp were reviewed by the Court of Appeal in Bishopsgate Investment Management Ltd v. Homan [1995] Ch 211 at pages 217 to 219, in which Dillon LJ affirmed the continuing authority of Re Diplock, and the rule that where trust money is paid into a bank account, tracing is defeated if that account becomes overdrawn, and is in any event limited to the lowest intermediate balance. The Court of Appeal also reaffirmed the *dictum* in James Roscoe (Bolton) v Winder [1915] 1 Ch 62 that:

> "Payments into a general account cannot, without proof of expressed intention, be appropriated to the replacement of trust money which has been improperly mixed with that account and drawn out."

188. In the present case, no-one suggested that payments made by LBIE into house accounts, after client monies attributable to un-segregated clients had wrongly been used for its own business purposes, were made with an expressed intention to replace misappropriated trust money.

189. The continuing vigour of the Re Diplock requirement, that the beneficiary must be able to identify his property by tracing, was specifically affirmed by the House of Lords in Foskett v. McKeown (*supra*), in particular in the following passage from Lord Millett's speech at [2001] 1 AC 130:

> "The simplest case is where a trustee wrongfully misappropriates trust property and uses it exclusively to acquire other property for his own benefit. In such a case the beneficiary is entitled *at his option* either to assert his beneficial ownership of the proceeds or to bring a personal claim against the trustee for breach of trust and enforce an equitable lien or charge on the proceeds to secure restoration of the trust fund. …

> Both remedies are proprietary and depend on successfully tracing the trust property into its proceeds. A beneficiary's claim against a trustee for breach of trust is a personal claim. It does not entitle him to priority over the trustee's general creditors unless he can trace the trust property into its product and establish a proprietary interest in the proceeds. If the beneficiary is unable to trace the trust property into its proceeds, he still has a personal claim against the trustee but his claim will be unsecured."

190. A much more recent attempt to resurrect the Space Investments general equitable charge over all the defaulting trustee's assets was firmly rejected by the Court of Appeal in Serious Fraud Office v. Lexi Holdings plc [2009] QB 376. Giving the judgment of the court, Keene LJ said this, in relation to Lord Templeman's *dictum* in Space Investments:

> "49. Based on this passage Mr Marshall submitted that where a trustee mixes trust funds with his own assets in such a way as to make it impossible for the beneficiary to identify which of the trustee's assets are affected by an equitable charge the court will impose the charge over all the assets of the wrongdoing trustee.
>
> 50. This cannot be right, in our view. For the equitable charge to attach it must attach to assets in existence which derive from the misappropriated trust funds. There must be a nexus. Were it otherwise the principles of following and tracing could become otiose. On the contrary, tracing in this area is a vital process: just because it is by that process that the necessary nexus is established and the proprietary remedy, be it by way of constructive trust or equitable charge, made effectual. It is for that reason that if all the misappropriated trust funds in any given case are paid into an account which was and remains overdrawn then the proprietary remedy is lost: for there are no identifiable assets left in existence deriving from the misappropriated trust funds, to which a constructive trust or an equitable charge could attach: see, for example, *In re Diplock* [1948] Ch 465, 521 and *Bishopsgate Investment Management Ltd v. Homan* [1995] Ch 211. In such a situation it is not open to a beneficiary to seek to shift the claim for an equitable charge to other assets which do not derive from the misappropriated trust funds."

191. Later, at paragraphs 52 to 53, the Court of Appeal reiterated the principle that the burden is upon the beneficiary to identify his property for the purposes of pursuing a proprietary remedy, rather than upon the trustee to show that some part of his assets are wholly unaffected by the beneficiary's claim.

192. The authorities which follow and comment upon Space Investments demonstrate that the second of the three theories advanced for the identification of un-segregated client money in a firm's house accounts is wrong, and that the third theory is correct. The

un-segregated clients must identify their property (outside the segregated accounts) by the established techniques of tracing, and may seek to appropriate a proportion of any mixed account to their proprietary claims by means of an equitable charge only if they can trace their property into that mixed account. Both the overdraft and minimum balance obstacles, well established and recently affirmed by authority binding on me, are likely to mean that it will prove extremely hard for un-segregated clients to do so, in relation to any failure to segregate their client money over a significant period of time. This will be all the more so in the case of a firm that has failed, since it will be inherently unlikely to have been running substantial surpluses on its house accounts during its descent into insolvency. For the reasons which I have given it will generally be impossible for un-segregated clients to establish a proprietary interest in funds paid into house accounts from the firm out of its other resources, since the necessary express intention that they should be a substitute for client money wrongly misused will, as in the present case, generally be absent.

193. It follows that the pursuit of such proprietary remedies in relation to a firm's house accounts by un-segregated clients will be a difficult, time consuming and contentious process. The relevance of all this is that it forms the backdrop of national law against which, consistent with the thrust of the MiFID Directives, CASS7 must be interpreted. When considering whether any client money other than that to be found in the firm's segregated accounts is intended to be swept into the CMP pursuant to CASS7.9.6R, for timely distribution to the clients entitled to it, the background is in my judgment as follows:

i) A compliant firm will have segregated all client money received (or appropriated to meet client money obligations) until a point in time just prior to its failure (i.e. the PLS in relation to a firm using the alternative approach).

ii) A non-compliant firm which has failed to recognise or apply its segregation obligations in relation to the money of some of its qualifying clients will have spent that money in its own business and, if it fails due to insolvency, probably have lost it.

iii) The identification and pursuit of misapplied client money will be time consuming, contentious, expensive and ultimately probably unrewarding.

iv) There may however be identifiable client money received by a firm (operating the alternative approach) during the short period between the PLS and the PPE, if not paid into overdrawn accounts, and subject to the minimum balance requirement.

194. Against that backdrop, it seems to me entirely understandable that CASS7 should deliberately have restricted the CMP to client money held, as at the PPE, in segregated accounts, as appears from the language of CASS7.9.6R(1). To require the CMP to be constituted by an expensive, slow, contentious and probably unrewarding search for identifiable client money elsewhere among the firm's assets would introduce, for no good purpose, a burdensome stage in the pooling and distribution of client money to the clients entitled to it out of all proportion to its likely reward, in the general run of cases.

195. There is in any event a persuasive symmetry between that part of CASS7 which requires the identification and segregation of client money by a firm while in business, and the distribution rules which, on that interpretation, require the money thus segregated to be promptly distributed to the clients entitled to it upon the firm's failure.

196. The CMP is however constituted only by client money in the firm's segregated accounts, and excludes money (if any) in those accounts which is not client money. Generally, it seems unlikely that there will be anything other than client money in segregated accounts, because the whole intent and purpose of the segregation requirements in CASS7 is to ensure that firms do not mix client money with their own money, at least beyond the short period between receipt and segregation, and then only under the alternative approach. There are however provisions in the rules which contemplate the possibility that money other than client money may be found in a segregated account. The main example is the mixed remittance which, pursuant to CASS7.4.23G a firm operating the normal approach is required to pay first into client account, before stripping out the non-client money element of it.

197. I therefore conclude in relation to issue three as follows:

i) The CMP is constituted as at the PPE only by client money in segregated accounts.

ii) Client money outside the firm's segregated accounts does not form part of the CMP.

iii) The identification of client money (if any) outside the firm's segregated accounts depends upon the established principles by which a beneficiary must trace his property in order to pursue a proprietary claim in relation to it, as laid down in Re Diplock, Re Hallett, Bishopsgate Investment Management v. Homan, Foskett v McKeown and, most recently, SFO v Lexi.

198. By way of postscript, I wish to make it clear that I reject the suggestion implicit in most of the submissions to the contrary, that the tracing principles to which I have referred are old-fashioned, unduly restrictive and therefore inappropriate for the protection of investors in the modern world. On the contrary, they represent the fruits of equity judges' and lawyers' endeavours over very many years to find and refine techniques of identifying and recovering trust property, in circumstances where the common law has failed to assist. The purpose of the process has been to help beneficiaries rather than to hinder them, and the techniques are only constrained by the unavoidable requirement to identify property to which it is appropriate to attach a proprietary claim. It is true that their use as an evidential tool can frequently be prohibitively slow and expensive, but this is usually the consequence of the evidential obstacles caused by the trustee's misappropriation of the property in the first place, not by any inherent or obviously curable defect in the tracing principles themselves.

4. – What provision do the CASS rules or the general law make in relation to identifiable client money which is not part of the CMP?

5. – Do the rules or the general law require or permit a shortfall in the CMP as at the PPE to be topped up, either from other non-pooled identifiable client money, or from the firm's general assets?

199. I have already dealt, under Main Issue 3 above, with the provision which the general law makes for the identification of client money outside a firm's segregated accounts. The statutory trust, imposed on client money from the moment of receipt by the firm, means that, if no provision is made to the contrary by the rules, a client may pursue a proprietary claim in relation to such money, if he can overcome the formidable evidential hurdles likely to be encountered on the way. For the reasons given at paragraph 143 above, I have concluded that a client may not establish any claim to money which the firm ought to have appropriated, but did not appropriate, from its own resources to meet a client money obligation to that client, since no trust arises until money is appropriated to meet that obligation, usually by segregation.

200. Against the risk that the court might construe CASS7.9.6R(1) as limiting the CMP to segregated accounts, the un-segregated client parties together with the FSA advanced a range of arguments in support of a case that the firm was obliged upon the happening of a PPE to top up the CMP thus constituted, either from identifiable client money mixed with the firm's money, or simply from the firm's money itself.

201. Synthesising those arguments as best I can, they ran thus:

i) A firm's segregation and reconciliation obligations in CASS7.4 and 7.6 did not, *ipso facto*, terminate upon the happening of a PPE. In particular, even if a firm had been fully compliant up to and including the PLS, it would nonetheless have to carry out a further reconciliation as at the PPE (but, in real time, necessarily after it) in order to distribute the CMP to the clients then entitled to it, because there were bound to have been further client money dealings between the firm and its clients between the PLS and the PPE.

ii) It followed that, following a reconciliation carried out by reference to the PPE, a firm was obliged to top up the CMP by reference to any shortfall revealed by that reconciliation.

iii) If that reconciliation as at the PPE, carried out on a proper basis and regardless of any systematic mistakes previously made by the firm, disclosed amounts of client money that ought to have been segregated in the past, then the CMP should be topped up by those additional amounts.

iv) The firm's obligation to top up should be satisfied either out of its general funds or, if that offended against established principles of English insolvency law, out of client money identifiable outside of the CMP.

202. These arguments were buttressed by a supposed symmetry with the case of the same respondents that the basis of a client's right to share in the CMP under the distribution rules was by reference to the amount which ought to have been segregated for that client, rather than the amount (if any) which was actually segregated. Put shortly, if

the inclusion of un-segregated clients as claimants to the CMP would, due to a firm's prior non-compliance with its segregation obligation to those clients throw up a large shortfall, then it was in accordance with the MiFID purposes that the shortfall should be made good by the firm. As will appear when I deal with Main Issue 6 below, I have not been persuaded that this is the correct interpretation of the distribution rules. Plainly, the two issues interact upon each other, and I have considered that interaction in my determination of each of them.

203. The proponents of the top-up theory gained some support from part of Sir Andrew Park's judgment in Global Trader (No 1) in which, at paragraphs 115 to 120, he decided that an insolvent firm should make a top-up payment to the CMP (or, as the case may be, deduction from the CMP) in relation to gains or losses in the value of clients' open positions between the PLS and the PPE, so as to put right a shortfall or surplus in the CMP arising since the PLS. Those respondents to this application which oppose the top up theory invite me to conclude that, in this limited respect, the decision in Global Trader (No 1) was wrong, and should not be followed.

204. The main objection to the recognition of any general top-up theory is that a PPE is usually (although not invariably) triggered by a firm going into some form of insolvency process, so that the recognition of a general obligation on the firm to top up the CMP out of its own resources would infringe the basic principle of insolvency law that a firm's own property is, subject to prior charges, to be distributed *pari passu* among its unsecured creditors. The insolvency code which has that principle at its heart applies just as much to a company in administration as it does to a company in liquidation, and takes effect from the date of the administration order: see Re Polly Peck (No 2) [1998] 3 All ER 812, at 827b per Mummery LJ.

205. There is copious authority to the effect that the court should not confer rights upon claimants against an insolvent company which would have the effect of preferring them to the general body of the company's creditors, unless those claimants can establish a proprietary claim to particular assets, thereby taking them out of the pool available for distribution in accordance with the insolvency code, or some valid form of security. I have already referred to the *dictum* of Lord Neuberger in the BA Peters case (*supra*). To the same effect is Mac-Jordan Construction v. Brookmount [1992] BCLC 350, per Scott LJ at 359 to 360. To do otherwise is, in the words of Mummery LJ in Polly Peck (*supra*) at 827f, to move "by judicial decision down a road signed 'No Entry' by Parliament".

206. It is of course competent to Parliament itself to legislate for exceptions to the *pari passu* principle in insolvency, and it has done so on rare occasions, for example in relation to corporation tax: see Re Toshoku Finance UK plc [2002] 1 WLR 671, by making the payment of corporation tax on profits arising in the winding up of a company payable as a liquidation expense.

207. A conclusion that CASS7 imposed an obligation on an insolvent firm to top up the CMP after the happening of a PPE from its own resources would require it to be shown, as a matter of interpretation, that:

i) Parliament had by sections 138 and 139 of FSMA empowered the FSA to impose regulations which made inroads upon the insolvency code; and

ii) the FSA had actually done so, pursuant to the Community obligation imposed by MiFID.

208. In my judgment, neither of those criteria is satisfied. First, the language by which Parliament has, on rare occasions, been held to have made inroads upon the insolvency code has been so clear as to admit of no other conclusion. Thus for example in Toshoku (*supra*) the conclusion was based upon section 8(2) of the Income and Corporation Taxes Act 1988, which provided that a company is "chargeable to corporation tax on profits arising in the winding up of the company". Nothing in sections 138 and 139 of FSMA comes anywhere near that degree of clarity.

209. Secondly, CASS7 does not do so either. First, CASS7 makes a generally (but not entirely) clear distinction between the client money rules and the distribution rules. The client money rules apply to a firm for as long as it is doing business as usual, and are replaced by the distribution rules upon the happening of a PPE. True it is that events other than the firm's insolvency may trigger a PPE (see CASS7.9.4R) but even those events are likely to bring business as usual to an end, since the effect of a PPE is to bring about the return of all segregated client money to the clients entitled, and to require the firm immediately to repay to clients any client money received after the PPE, under CASS7.9.9R. Indeed, the heading of CASS7.9.9R and other provisions in CASS7 implicitly assume that any kind of PPE will either bring about or follow upon the failure of the firm.

210. It is true that certain parts of the detail of the client money rules are specifically incorporated by reference into the distribution rules. For example, CASS7.9.6R(2) expressly incorporates CASS7.7.2R, and the obscure requirements of CASS7.9.7R at least require reference to parts of the client money rules, including Annex 1, in order to begin to understand what it means. Furthermore, as will appear below, the calculation of clients' entitlement to share in the CMP does require a limited form of reconciliation to be carried out as at the PPE (and therefore, necessarily, after it in real time).

211. Nonetheless none of those elements of the distribution rules are in my judgment sufficient to prolong beyond the PPE any obligation of the firm to top up the CMP by a further segregation of client money, *a fortiori* where to do so would require the firm to have recourse to assets which, following the making of an administration order or presentation of a winding up petition, are pursuant to the insolvency code to be distributed *pari passu* among its unsecured creditors.

212. It is fair to say that, as argument developed during the hearing of this application, the proponents of the top-up theory came to recognise the insuperable difficulties represented by the inroads which their arguments would make into the integrity of the insolvency code so that, by the time of reply submissions, the top-up case had become mainly confined in its effect to client money identifiable elsewhere than in the segregated accounts. It was specifically to satisfy such a top-up obligation that the un-segregated client parties and the FSA advanced their alternative theories whereby proprietary claims to client money could be advanced by the assertion of floating or equitable charges over broad classes of LBIE's house accounts and other assets. I have rejected those arguments, with the consequence that the limitation of the top-up case to client money identifiable outside the CMP will itself involve the same long,

expensive, contentious and probably unrewarding exercise that adversely effected the argument that un-segregated money was to be interpreted as forming part of the CMP in the first place.

213. In my judgment CASS7 does not impose a post PPE top-up obligation, even in relation to client money identifiable outside the CMP. My main reason is because the client money rules are replaced by the distribution rules upon the happening of a PPE, and no segregation obligation is to be found in the distribution rules either expressly, or by incorporation by reference. It is, ultimately, a short point of interpretation. Specifically, the only provision in the client money rules which expressly requires a top-up after a reconciliation reveals a shortfall, namely CASS7.6.13R(1), is in my view clearly not part of the distribution rules, and ceases to have effect upon the happening of a PPE. It is no answer to say that the top-up obligation arises precisely at the time of, rather than after, a PPE. In real time, any reconciliation and top-up would have to take place thereafter, by which time the relevant rules would have ceased to have effect.

214. The strongest argument to the contrary, with which I have not found it easy to grapple, is that this conclusion leaves a curious black hole or lacuna in the rules, to be filled by the general law. The starting point is that, even in a perfectly compliant firm which uses the alternative approach, there may well be client money received by the firm into house accounts since the PLS, but before the PPE. It is possible, although I think generally unlikely, that such receipts of client money may in aggregate exceed payments out of client money during the same short period, so as to give rise to a shortfall in the CMP as against client money entitlements calculated as at the PPE. Furthermore, as appears to have occurred in <u>Global Trader (No 1)</u>, changes in the value of clients' open positions with the firm may have increased their client money entitlements, valued as at the PPE since the PLS. Such increases, quite separately from the net inflow or outflow of client money, may themselves give rise to a shortfall, particularly if they are (as in <u>Global Trader</u>) OTC positions, rather than exchange traded positions backed by segregated client transaction accounts.

215. Whereas the distribution rules deal at CASS7.9.6R with all client money in segregated accounts as at the PPE, and CASS7.9.9R deals with client money received after the PPE, nothing in the distribution rules deals with client money received but not segregated by a firm using the alternative approach between a PLS and the PPE.

216. The guidance in CASS7.9.8G (to the effect that the client will be an unsecured creditor of the firm in respect of any shortfall against money held in the firm's own account) seeks to fill that lacuna, but in a manner unattractive to clients. So unattractive is that paragraph that Mr Knowles repudiated it on behalf of the FSA as being wrong.

217. This lacuna or black hole is the same as that with which it was necessary for me to deal when considering the question whether CASS7 creates a trust upon receipt of client money. In relation to gains in the value of clients' open positions with the firm, it was the same lacuna that led Sir Andrew Park to conclude, after evident hesitation, that the firm owed a top-up obligation for the purposes of making good any consequential shortfall, in <u>Global Trader (No 1)</u>. By contrast Sir Andrew Park reached the opposite conclusion in relation to transfers of money from house to client account in respect of which the firm had given instructions prior to the PPE, but with

which its bankers had not by that date complied: see paragraphs 102 to 115. But the subject matter of what he described as that "incomplete transfer" was not money to which the clients could establish a proprietary claim, so that a top-up obligation in relation to it would have offended against the insolvency code. More generally, it does not appear that Sir Andrew Park thought it at all likely that identifiable client money would ever be found outside the firm's segregated accounts, although he was invited to, and did, leave that question open.

218. Sir Andrew Park's conclusion that the firm owed a top-up obligation for the purpose of making good shortfalls caused by gains in the value of clients' open positions between the PLS and the PPE appears to have been based upon an assumption that the shortfall in question was actually caused by the firm going into administration. At paragraphs 116 to 118 of Global Trader (No 1) he contrasted the shortfall caused by the firm's bank not having complied in time with a segregation instruction as not having been caused by the administration, whereas a shortfall arising from gains in clients' open positions, valued as at the PPE was, in his view "a direct result of the company going into administration". On that basis, he concluded that a purposive interpretation of CASS7 required the identification of an implied top-up obligation to make good that second type of shortfall, but he provided no explanation why the recognition of that obligation was any less an inroad into the insolvency code, than the recognition of an obligation to make good a shortfall caused by under-segregation.

219. Sir Andrew Park expressly recognised the difficulties in reconciling those two alternative conclusions about different types of shortfall, and his conclusion that the fact that, as he saw it, one was but the other was not the direct consequence of the administration was his solution to the difficulty. Almost all the parties to this application submitted that, in truth, Sir Andrew Park's opposite conclusions in relation to those two different types of shortfall were irreconcilable, such that one or other of them must be wrong.

220. With respect to Sir Andrew Park, I agree. In the first place, the open positions in Global Trader had arisen through OTC trades between the relevant clients and the firm, in respect of which the clients' entitlement to profits was essentially contractual. Pending the appropriation by the firm of money from its own resources as client money to meet that contractual obligation, the relevant clients were just as much unsecured creditors in respect of those profits as were the clients for whom the firm had attempted, but failed, to make a further segregation by means of the incomplete transfers. The making good of either of those shortfalls out of the firm's own resources would have amounted to an inroad upon the insolvency code, by preferring the clients to the firm's other unsecured creditors.

221. Furthermore, I have been unable to understand why the shortfall caused by the valuation of unrealised profits as at the PPE was any more a shortfall caused by the administration than the shortfall caused by the incomplete transfer of the intended segregation payments. They appeared only to have been caused by the administration because David Richards J. had directed, at an earlier hearing, that the date for calculating clients' entitlements to the CMP was the PPE, so that a notional valuation of clients' open positions had to be carried out as at that date. In reality, the clients' positions improved in value between the PLS and the PPE not because of the administration (which merely caused that increase to have to be recognised for the

purposes of calculation). The increase incurred because of movements in the market for the relevant OTC investments.

222. But even if it could be said that the administration was in some way a more direct cause of the valuation shortfall than of the shortfall caused by the incomplete transfers, I do not consider that this affords any sufficient basis for concluding that the firm had an implied top-up obligation in relation to the first shortfall, but not in relation to the second. The onset of insolvency typically causes all kinds of contingent obligations of a company to crystallise, so as to create unsecured liquidated debts in respect of which the creditors concerned must prove for a *pari passu* distribution with all other creditors.

223. I have therefore concluded that there is no satisfactory explanation to the inconsistency between those two different approaches applied by Sir Andrew Park to shortfalls in the CMP with which he had to deal. For reasons which will be apparent, I consider that a firm owes no top-up obligation to clients in respect of either type of shortfall, either from its own resources, or from identifiable client money outside the CMP. It is in my judgment illogical to conclude first that the CMP is confined to segregated client money, and then to conclude that there is an unwritten but implied top-up obligation to make good any adverse consequence arising from that interpretation of CASS7.9.6R(1). The same difficulties of delay, expense and dispute affect both arguments.

224. In my judgment the lacuna is sufficiently filled by the general law, which permits those clients whose money is identifiable within house accounts, and not therefore part of the CMP, to pursue proprietary claims for its recovery, if they can surmount the evidential obstacles imposed by the need to trace.

225. Mr Zacaroli submitted that, if the choice for filling the lacuna consisted of (1): client money going to the individual contributing clients under the general law (subject to tracing); (2) the money going to the creditors; and (3) the money being added to the CMP, the fairest solution was (3). He added that this was consistent with CASS7.7.2R(1), applying the distribution rules to all client money held subject to the statutory trust. This was a powerful submission, but I was not in the end persuaded by it.

226. As to fairness, there is of course much to be said as a general proposition for the pooling of all client money, but this appears to be contrary to the express terms of CASS7.9.6(1), in which the words "held in each *client money* account of the *firm*" would be otiose if the distribution rules were to apply to all client money regardless of its whereabouts as at the PPE. Secondly, fairness depends upon the perspective of the onlooker. A client whose money is pooled shares in all the misfortunes which affect the CMP, including in particular the credit loss occasioned in the present case by the failure of Bankhaus. By contrast, a client whose money was received by the firm so soon before its failure that it was never segregated may consider it fairer to be able to pursue a recovery of that money, if still identifiable in house accounts, free both from the benefits and burdens affecting money actually segregated, and therefore pooled. Put another way, it was money which the client paid to the firm for the purpose of being segregated. If that purpose fails he should under conventional principles be able to have it back again in full if he can find it.

6. – Is the basis for sharing in the CMP the amount which ought to have been segregated for each client, or the amount which was in fact segregated (the claims basis and the contribution basis for sharing)?

227. This is a difficult question, with large consequences on the particular facts of this case. The claims of LBIE's un-segregated clients exceed in amount the face value of the CMP, even before taking account of the shortfall caused by the Bankhaus failure. If the contributions theory is correct, the un-segregated clients will get nothing from the CMP. If the claims theory is correct the clients whose money was actually contributed to the CMP will suffer a more than 50% reduction in their receipts from the CMP attributable to the inclusion as claimants of the un-segregated clients. In either case, the aggregate of the consequences will probably exceed US$1 billion.

228. Unhappily, CASS7 provides no clear guidance on this question. This is probably because the draftsman working in the utopian world of full compliance by the firm with the client money rules before its failure, assumed that there would be no substantial difference between the amount which should have been segregated and the amount which was actually segregated for any particular client. The only differences would arise from dealings with client money during the short period between the PLS and the PPE, and then only in relation to a firm using the alternative approach.

229. I shall briefly summarise the rival arguments. For the claims theory, it was submitted first that a sharing in the pool based on the amounts which should have been segregated more faithfully implements the purposes of the MiFID Directives. Secondly, it was submitted that a close analysis of CASS7.9.6R, 7R and 9R demonstrates that the prescribed basis of calculating each client's claim upon the CMP necessarily required a form of internal reconciliation based upon what should have been, rather than what was, segregated for that client.

230. For the proponents of the contributions theory, it was submitted first that the pooling and distribution of client money prescribed by CASS7 should be regarded as a particular type of *pari passu* distribution to persons with proprietary claims to a mixed fund affected by a shortfall, well recognised by the general law, and that such schemes generally proceeded upon the basis of a sharing between those with proprietary claims, rather than a sharing which admitted others to the table who had no proprietary claims to the mixed fund.

231. Secondly, it was submitted that to admit the claims of un-segregated clients would frustrate an express primary purpose of the distribution rules, namely the prompt and efficient distribution of the pool to those entitled to share in it, since the investigation and, if necessary, litigation of claims by alleged un-segregated clients (which, *ex hypothesi*, the firm had never acknowledged in its own accounts) would cause grave delay in the distribution of the pool, even on an interim basis. Thirdly, it was submitted that the contributions basis was expressly approved by Sir Andrew Park in Global Trader (No 1), as indeed it was.

232. I have not found this question easy to determine. In particular, it calls for an investigation and understanding of the meaning and purpose of CASS7.9.7R, an obscure provision which Sir Andrew Park confessed to have found "a very difficult subparagraph", but one about which he considered it unnecessary to reach any conclusion: see Global Trader (No 1), at paragraph 120.

233. I consider that the starting point is to recognise that it was competent to the FSA to choose either of the rival theories as the basis for the distribution rules in CASS7.9. I was referred to examples of other types of statutory client money and distribution schemes which adopted each approach.

234. Secondly, I do not derive decisive assistance from an analysis of the purposes behind the MiFID Directives, in resolving this issue. On the one hand it may be said that the general aspiration to provide a high level of investor protection is best served by conferring a right to share in the CMP upon all clients whose money should have been segregated, whether or not it was. On the other hand, the MiFID Directives are, as I have sought to explain, aimed at the establishment of obligations and organisational requirements which, if complied with, would protect clients' funds both from misuse by the firm, and from loss occasioned by the firm's insolvency. The contemplation of the Directives was that this would be achieved by identification, reliable accounting and segregation, such that clients' money actually dealt with in that way would be protected, but not otherwise.

235. Viewed in that way, I consider that the MiFID Directives tend to support a contributions rather than claims based approach to distribution, albeit that they are, in their express terms, silent about the manner of distribution of clients' funds upon the firm's failure.

236. Next, it is in my judgment correct to regard the distribution rules in CASS7.9 as a particular example of the approach taken by the general law to cases where a mixed trust fund has suffered a shortfall as the result of causes for which the beneficiaries bear no responsibility, or for which none bears any greater responsibility than any other. Examples of such *pari passu* distribution arrangements in the authorities which I was shown include Sinclair v. Brougham [1914] AC 398, Re Eastern Capital Futures Ltd (1989) 5 BCC 223, and Commerzbank Aktiengesellschaft v. IMB Morgan plc [2004] EWHC 2771 (Ch). They are all applications of the principle in Re Hallett's Estate (1880) 13 Ch. D 696.

237. An essential prerequisite in all those cases was for the claimant beneficiary to show, by conventional means, that he actually was a contributory to the mixed trust fund in respect of which there had been a shortfall. In other words, the technique of *pari passu* distribution was part of the technique by which in those cases equity gave effect to proprietary claims, properly established pursuant to the requirements laid down in Re Diplock *(supra)* and the other cases to which I have referred. Needless to say, if the scheme for pooling and *pari passu* distribution contained in CASS7.9 is treated as a statutory descendant of such schemes as have been applied by the general law, this firmly supports the contributions theory as the basis for sharing in the CMP. Absent contribution, the client's proprietary claim never gets off the ground.

238. That conclusion is fortified by a careful analysis of the proprietary interests affecting the segregated accounts immediately prior to a PPE, as declared by CASS7.7.2R, and by subparagraph (2) in particular. Prior to a PPE the segregated client money is held by the firm as trustee for the purposes and on the terms of the client money rules (since the distribution rules lie, at that stage, in the future) and, subject to that, (and to the contingent claims under subparagraph (4) which also arise only on failure of the firm), "for the *clients* for whom that *money* is held, according to their respective interests in it." *Ex hypothesi*, the firm had not segregated at that point any money for

un-segregated clients, and it would be hard to construct a case, prior to the PPE, upon which the client money in segregated accounts could be said to be held on trust for un-segregated clients.

239. A more detailed analysis of the precise basis upon which, prior to a PPE (and pooling), client money is held shows that it is not necessarily even held as a fund for clients in general. The segregated accounts include designated client bank accounts, in which the beneficial interests are limited to the specific client or clients whose money is held in those accounts: see in particular the explanation in CASS7.9.3G. The same conclusion may be derived from an analysis of CASS7.6.1R, which requires the firm to keep records and accounts sufficient to enable it to distinguish client money held for one client from client money held for any other client. See also CASS7.6.6G, 7.7.1G and 7.9.21R(1).

240. Upon the happening of a PPE, there is, of course, a general pooling of all segregated accounts and therefore also of the beneficial interests of clients in segregated accounts across the board: see again CASS7.9.3G. The result is that they all share *pari passu* in the misfortunes and shortfalls which affect the segregated client money generally. But it would go a great deal further to require those clients who have contributed to the CMP also to share the misfortune of un-segregated clients, whose money has never been contributed to any segregated account, and who have, therefore, no proprietary claim of any kind prior to the PPE, and a claim thereafter only if CASS7.9 thus radically adjusts their interests.

241. The result is in my judgment that the MiFID Directives, the general law and an analysis of the proprietary rights in the segregated accounts prior to pooling, all support the contributions theory as against the claims theory. There remains nonetheless the question whether, as submitted by (and for) the un-segregated clients, the language of the distribution machinery contained in CASS7.9.6R, 7R and 9R requires the application of a claims rather than contributions basis of calculation as a matter of interpretation. For that purpose, there is no escape from a painstaking analysis of the meaning and purpose of those three paragraphs, and in particular paragraph 7.9.7R.

242. I have already quoted the relevant parts of CASS7.9.6R, 7R and 9R at paragraph 125 above. The argument of the proponents of a claims basis for distribution, based on these paragraphs, runs as follows:

i) CASS7.9.6R(2) requires the firm to distribute *client money* "in accordance with CASS7.7.2R, so that each *client* receives a sum which is rateable to the *client money* entitlement <u>calculated in accordance with CASS7.9.7R"</u> (my underlining).

ii) CASS7.9.7R requires, on a client by client basis, a netting process to be carried out between each client's "individual *client* balance" and that client's "*client equity balance*".

iii) CASS7.9.9R(2) makes it clear (albeit for a different purpose) that the "*client money* entitlement" for each client will be calculated in accordance with CASS7.9.7R as at the time of the PPE.

iv) The phrase "*client equity balance*" is defined in the Glossary by reference to the amount which a firm would be liable to pay to a client in respect of that client's margined transactions if each of his open positions was liquidated at the prices published by the relevant exchange and his account closed. It is a form of entitlement having nothing to do with the amount contributed by the client to the firm's segregated accounts.

v) The phrase "individual *client* balance" is not a term defined in the Glossary, but it is fully explained in paragraph 7 of Annex 1, again in terms which are based upon the contractual position between the client and the firm, rather than the amount actually contributed by the client to the firm's segregated accounts.

vi) Thus it necessarily follows that the phrase "*client money* entitlement", where used both in CASS7.9.6R(2) and 7.9.9R(2) is a reference to the client's contractual entitlement to have money segregated for it, rather than to the client's proprietary interest in the CMP, derived from having had its money actually segregated, i.e. paid into the segregated accounts from which the CMP is constituted.

vii) By way of a postscript, Mr Knowles submitted that, in any event, not all contributions to the segregated accounts were made in respect of particular clients. For example, he pointed to the prudential payments contemplated by CASS7.4.21R. Segregation in relation to depot breaks is another example: see below.

243. This is a formidable textual argument, but I have not, after anxious thought, finally been persuaded by it. Its principal weaknesses are, first, that CASS7 uses the partially defined phrase "*client money* entitlement" as meaning different things in different places, so that its meaning in any particular paragraph must be informed by its context. Secondly, it is I think wrong to impute to the draftsman a consciousness of a significant potential difference between a right to share in the CMP based upon contractual entitlement, and a right to share based upon contribution, still less an intention by the use of the language of the distribution rules to distinguish between the two in favour of the former.

244. The first of those weaknesses may be illustrated by three examples. CASS7.9.21R provides for a recalculation of client money entitlements arising from the secondary pooling event constituted by the failure of a client account bank. It clearly uses the phrase "*client money* entitlement" by reference to the clients whose money was actually segregated in those segregated accounts affected by that bank's failure. It would for example be impossible to apply that phrase in CASS7.9.21R to any un-segregated client (i.e., a client whose money had not been segregated at all, let alone into those particular accounts, notwithstanding his contractual right to the contrary).

245. By way of contrast, the phrase "*client* entitlement" is used in CASS7.4.27G and 28G simply as a reference to a monetary asset. Finally, in CASS7.4.16G the concept of a client's entitlement is used as a reference to the money which a client is contractually entitled to have segregated.

246. The second weakness in the argument is, as I have sought to explain, a consequence of the thrust of the MiFID Directives, which seek to achieve investor protection by

requiring firms to comply with (rather than to commit breaches of) the relevant organisational requirements. This led the draftsman of CASS7 to construct a scheme of obligations with which he expected firms to comply, rather than flout.

247. In my judgment the correct interpretation of CASS7.9.6R, 7R and 9R is as follows. First, the underlying objective of the pooling and distribution regime triggered by a PPE is the timely distribution back to clients of their money (i.e. "*client money*") once no longer capable of being used for business transacted for clients, by reason of the failure of the firm. This objective is expressly stated in CASS7.9.2G.

248. The intention that this process of distribution upon the firm's failure should be achieved promptly and efficiently is expressly recognised in the FSA Consultation Paper 06/14, entitled 'Implementing MiFID for Firms and Markets', at paragraphs 10.17-18, at page 56, published in July 2006. Those same paragraphs demonstrate the FSA's assumption (which also underlies the drafting of CASS7) that the creation of the statutory trust, and the segregation of all client money subject to that trust, will create a fund from which that prompt and efficient distribution can take place upon the firm's failure. Distribution will thus be made to the clients beneficially entitled to that fund.

249. Secondly, the concept of pooling and rateable (i.e. *pari passu*) distribution prescribed by the distribution rules is designed both to contribute to the speed and efficiency of the distribution process, and to deal fairly, as between the beneficiaries entitled to share in the pool, with any shortfall. In short, as I have explained, it establishes a particular form of the *pari passu* system of distribution which in appropriate cases the general law will itself apply where there is a shortfall in a fund in which the proprietary interests of numerous beneficiaries are mixed.

250. Thirdly, it is no part of the purpose of the distribution rules to confer upon clients whose money was, in breach of the client money rules, not contributed to the segregated accounts from which the CMP is constituted, a beneficial interest in that fund which did not exist immediately prior to the PPE. This is implicit in the opening words of CASS7.9.6R(2) which require the firm to: "distribute that *client money* in accordance with CASS7.7.2R" and in the words of CASS7.7.2R(2) which provide that, subject to the client money rules and distribution rules, and to the payment of expenses, client money is held on trust "for the *clients* … for whom that *money* is held, according to their respective interests in it". The phrase "that *client money*" in CASS7.9.6R(2) is clearly a reference to the client money in the segregated accounts, and therefore in the CMP: see CASS7.9.6R(1), and my interpretation of that subparagraph in paragraphs 166ff above. Immediately prior to the PPE, that money was held for the clients beneficially entitled to it, i.e. the clients on whose behalf the firm had actually made payments into the segregated accounts.

251. If CASS7.9.6R(2) had ended there, there could to my mind have been no doubt that the right to receive a distribution from the CMP was limited to those clients for whom the firm had actually segregated client money. The question remains, do the concluding words of CASS7.9.6R(2) and the contents of CASS7.9.7R thereby referred to, alter that conclusion?

252. CASS7.9.6R(2) continues:

> "… so that each *client* …"

Again, *prima facie* the phrase "each *client*" is a reference back to the clients identified in CASS7.7.2R(2), i.e. to those for whom the firm had actually segregated client money.

253. The subparagraph continues:

> "… receives a sum which is rateable to the *client money* entitlement …"

This is the phrase which provides for a rateable or *pari passu* distribution in the event of a shortfall. Otherwise, it adds nothing to the impression thus far created that the distribution is to be only to those clients for whom the firm has actually segregated client money.

254. Subparagraph (2) then concludes with the phrase:

> "…calculated in accordance with CASS7.9.7R."

It is this concluding phrase, and its incorporation of CASS7.9.7R, that lies at the heart of the argument of the protagonists for a claims basis of sharing in the CMP. Put another way, the case for rejecting a contribution basis rests wholly on an understanding of CASS7.9.7R, to which I now turn.

255. The first thing to notice about CASS7.9.7R is that it does not purport to constitute a comprehensive formula for the calculation of a client money entitlement. It merely provides for the offset of two particular types of accounting debit against two particular types of accounting credit. By subparagraph (1) a positive individual client balance is to be reduced by offsetting a negative equity balance. By subparagraph (2) a positive client equity balance is to be reduced by any negative individual client balance. It says nothing about the situation where a client has positive balances, or negative balances, of both types. It is, as Mr Zacaroli described it, a reducing mechanism. Its effect is, in the stated circumstances, to reduce what otherwise might have been identified as a client's client money entitlement, which is to serve as the basis for his rateable participation in the CMP.

256. In the case of a reasonably compliant firm, it may be assumed that the basis upon which the firm had segregated client money for each of its clients prior to the PPE would be disclosed from the last internal client money reconciliation account, upon the basis of which (for example) a firm using the alternative approach would have adjusted the amount of the segregated accounts as at the PLS. The standard method of client money reconciliation is set out in Annex 1. It requires a firm on each business day to identify its "*client money* requirement" (as defined by paragraph 6) and to ensure that its "*client money* resource" is at least equal to the client money requirement.

257. The firm's client money requirement is (in the first of two alternative formulations in paragraph 6) the aggregate of all individual client balances, excluding negative client balances and client equity balances, together with the total margined transaction requirement, which is (as appears from paragraph 14) the aggregate of all positive

client equity balances, subject to certain deductions which do not matter for present purposes.

258. Paragraphs 12, 18 and 19 of Annex 1 give the firm certain discretions as to how to carry out these calculations. In particular, paragraph 18, as explained by paragraph 19, under the heading 'Reduced client money requirement option', permits, but does not require, a firm to carry out precisely the same offsetting process as is made mandatory after a PPE by CASS7.9.7R.

259. That analysis of Annex 1 shows that a firm adopting the standard method of internal client money reconciliation as at the PLS (i.e. just prior to the PPE), and which does not choose to avail itself of the Reduced client money requirement option in paragraphs 18 and 19 of Annex 1, will be likely to have segregated for clients with negative individual client balances or negative client equity balances more than the amount which it would have segregated for those clients if it had availed itself of that option. By contrast, for the purposes of identifying the client's rateable entitlement to the CMP after the PPE, CASS7.9.7R makes that offsetting process compulsory, so as to reduce the entitlement of clients with relevant negative individual or equity balances below that which might otherwise have been derived from an inspection of the last internal reconciliation account used as at the PLS.

260. Why, it may be asked, should it have been thought necessary or appropriate to include CASS7.9.7R as part of the distribution rules? Its practical effect would be, in relation to a CMP which suffered from no shortfall, to create a surplus for payment back to the firm under CASS7.7.2R(5). In relation to a CMP in shortfall, it would create a sum for rateable distribution among the contributing clients generally, so as to reduce the shortfall by the use of money contributed for clients in excess of that which would have been contributed had the firm taken advantage of the Reduced client money requirement option in paragraphs 18 and 19 of Annex 1. It is therefore a reducing mechanism which limits each client's client money entitlement to that to which the firm could have limited it, prior to the PPE, under paragraphs 18 and 19 of Annex 1, whether in fact the firm did or did not do so. It thereby generates a sum which mitigates the injustice to contributing clients generally which may be caused by a shortfall and which, in the absence of such a shortfall, becomes available for the insolvent firm's general creditors by way of surplus under CASS7.7.2R(5).

261. If this is, as I conceive it to be, the correct interpretation of CASS7.9.7R, does it necessitate a conclusion, contrary to all the other indicators which I have described, that the basis of sharing in the CMP is a client's entitlement to have its money segregated, rather than a client's contribution to the segregated accounts, as revealed by the last internal reconciliation accounts carried out as at the PLS? In particular, does it thereby require the firm, or any other trustee of the CMP (in practice the firm's relevant office holder) to go behind that last internal reconciliation account to establish, if necessary by enormous forensic endeavour and even litigation, the true contractual entitlements of the firm's clients to have their money segregated, without limitation in historical time, so as to include un-segregated and partially segregated clients as beneficiaries of the CMP, with obvious adverse consequences in terms of the timely and efficient distribution of the pooled client money to the clients entitled to it?

262. In my judgment, viewed in that light, the answer is clearly in the negative. I consider that the "*client money* entitlement" which serves as the basis for a client's rateable sharing in the CMP pursuant to CASS7.9.6R(2) is therefore the amount shown in the firm's last internal client money reconciliation accounts to have been contributed by way of segregation to the fund which became the CMP, for that client, subject to a possible downward adjustment pursuant to CASS7.9.7R where:

(a) The firm in question did not prior to the PPE take advantage of the Reduced client money requirement option in paragraphs 18 and 19 of Annex 1; and

(b) There exists in the account for that client forming part of the last internal reconciliation accounts a relevant negative individual client balance or client equity balance capable of being set off against a positive balance of the opposite type.

There may be certain other downward adjustments to be made, to which I shall shortly return.

263. That process of downward adjustment would not undermine the timeliness or efficiency of the application of the distribution rules, since it is primarily to the last internal reconciliation accounts that the trustee of the CMP will have to have recourse, in ascertaining what each client's client money entitlement is, for the purposes of CASS7.9.6R(2).

264. In conclusion, I have not been persuaded by Mr Knowles' submission that a contributions basis of claim to share in the CMP is undermined by the fact that a firm may segregate money which is not attributable to any particular clients, pursuant to CASS7.4.21R or otherwise. In the case of a firm which (like LBIE to a limited extent) took advantage of CASS7.4.21R by making prudent payments in excess of specific client entitlements into the segregated accounts, that amount will serve either as a means of reducing what would otherwise be a shortfall in the CMP, or to the extent that there is anything left over after a shortfall is eliminated, will constitute a surplus repayable to the firm pursuant to CASS7.7.2R5). There is obvious commonsense and justice in that outcome, and it is no way inconsistent with the calculation of the client money entitlement referred to in CASS7.9.6R(2) by reference to the contributions shown to have been made to the segregated accounts by the firm's last internal reconciliation accounts.

265. There is a final potential glitch in my interpretation of the distribution rules which I have set out above, which arises from the inevitability that a short period of time will expire between the PLS (to which the last internal reconciliation accounts will relate) and the PPE, during which events may occur which would increase or reduce the amount which the firm would ordinarily segregate for a client, if it carried out a further segregation as at the PPE. Events which might increase a client's entitlement include an increase in the value of open margined positions, thereby reducing variation margin and increasing that client's client equity balance, and receipts by a firm operating the alternative approach into house accounts from or on behalf of clients which will, by definition, not have found their way into segregated accounts following the PLS.

266. Events which might reduce a client's entitlement to share in the CMP, calculated as at the PPE, include reductions in the value of the client's margined open positions, and payments to the client from house accounts from a firm operating the alternative approach. I will call these events "increasing events" and "reducing events" respectively.

267. CASS7 makes no express provision about this glitch, hence Mr Peacock's description of it as an intra-day risk with which neither MiFID nor CASS7 deals in any way. The claims basis for sharing in the CMP naturally accommodates these events, because they all adjust the relevant client's contractual entitlement to have client money segregated for him. By contrast, the contributions basis for sharing offers no such ready solution, since increasing events will (usually) have led to no additional contribution to the segregated accounts, nor will reducing events (usually) have led to any payment out of those accounts. Exceptionally, those events may have a corresponding effect on the segregated accounts, as where a change in the value of an open margined position leads to an adjustment in the relevant client transaction account: (see below). Subject to that exception, the CMP will, on either theory, be slightly out of kilter by reference to those events. As will appear when I come to consider the date for calculation of clients' entitlements to share in the CMP, the glitch constituted by events occurring during the short period between the PLS and the PPE does not in all respects end at the PPE. Changes in the value of clients' open positions will continue thereafter until those positions are finally closed out. Furthermore, clients' contractual entitlements to client money in currencies other than that which constitutes the bulk of the CMP will also fall out of kilter with their shares in the CMP, if those shares are calculated as at the PPE. True it is that increasing or reducing events caused by money payments will cease as at the PPE, not least because CASS7.9.9R requires the firm immediately to open new bank accounts for the receipt of client money thereafter, and to pay it back to the clients entitled. In its context therefore, this glitch is one of a number thrown up by any interpretation of CASS7 with which, as it seems to me, those responsible for framing the rules did not grapple.

268. The proponents of the contributions basis for sharing the CMP, principally Mr Zacaroli, were disposed to acknowledge that at least some relevant events occurring between the PLS and the PPE would call for a downward adjustment to be made to the amount by reference to which particular clients should share in the CMP. For example, Mr Zacaroli readily accepted that a client with US$100 segregated for him as at the PLS, who then requested and was paid that sum in full out of house accounts (by a firm using the alternative approach) before the PPE, could hardly expect to have any claim to share in the CMP allocated to him by way of client money entitlement. He had, quite simply, been repaid in full.

269. I consider this acknowledgment to be well made. It would be necessary, even under the contributions basis, to abate the client money entitlement of a client shown in the firm's last internal reconciliation accounts by reference to any amount of client money received by him from the firm's house accounts between the PLS and the PPE. Otherwise he would be paid twice over.

270. By contrast, a client who (blissfully ignorant of the firm's imminent demise) paid US$100 into the firm's house accounts, could claim no contributions basis for sharing in the CMP in respect of it, because it would not have been segregated. Nonetheless as I have explained, having made a payment for the purpose of segregation which had

failed, he would in my judgment be entitled to pursue a proprietary remedy in respect of that payment, if he could trace his US$100 in the firm's house accounts.

271. The position in relation to clients whose open positions changed in value between the PLS and the PPE is more complex. If those positions were margined by means of the firm's use of client transaction accounts (as in LBIE's case) then an increase in value of an open position would lead to a corresponding credit to the relevant client transaction account by release of an equivalent amount of variation margin by the relevant clearing house or intermediate broker. Reductions in the value of open positions would, similarly, lead to appropriate reductions in the relevant client transaction accounts.

272. It follows from that analysis, that by contrast with client bank accounts, client transaction accounts are, to an extent, self-adjusting by reference to changes in the value of clients' open positions, and do not call for daily adjustments pursuant to internal client money reconciliations. In relation therefore to exchange traded positions, the amounts in client transaction accounts are constantly responsive to changes in the value of clients' open positions, in particular between the PLS and the PPE. The position is otherwise in relation to OTC transactions, which operate purely in contract between the firm and its client, and which constituted the bulk (if not the entirety) of the open positions considered by Sir Andrew Park in Global Trader (No 1). In relation to such positions, increases in value between the PLS and the PPE will trigger an obligation on the firm to segregate money for the client which will, *ex hypothesi*, not have been performed as at the PPE. Since those obligations fall to be fulfilled by the firm's appropriation of an amount from its own resources (usually by segregation), those increasing events give rise to no trust consequences, for reasons which I have already explained. In my judgment, their consequences lie purely in contract as between the firm and the clients in question.

273. I shall have to address some of these increasing and reducing consequences when dealing with the detailed questions which I have been asked to resolve. For present purposes the question is, does their existence constitute a fatal obstacle to the interpretation of the distribution rules in accordance with the contributions theory? In my judgment the answer is again in the negative. As a blemish on an otherwise rational interpretation of the client money and distribution rules as a whole, they come nowhere near the difficulties, in particular of delay, expense, inefficiency and potential for litigation which would arise from an adoption of the claims theory. Furthermore, the general law is, as I shall endeavour to explain below, adequate to remedy such injustices as the application of the contributions theory to such events would otherwise cause.

274. I must deal finally under this heading with a fallback argument advanced by the partially segregated clients, which came to be known during the hearing as the "piggy back argument". This was that even if clients for whom no money had been segregated were excluded from sharing in the CMP, a client for whom some money had been segregated could share on the basis that his client money entitlement represented the whole of that which should have been segregated. This argument was advanced with brevity and an evident lack of enthusiasm, and I have no hesitation in rejecting it. In my judgment, partially segregated clients are, save for the amount actually segregated for them, in no better position than an un-segregated client.

275. My conclusion on this issue therefore is that the basis for sharing in the CMP is the amount which the firm actually segregated for each client, as revealed by the last internal reconciliation account carried out by the firm before the PPE, and in LBIE's case (because it used the alternative approach) by reference to the PLS, subject to certain adjustments necessitated by CASS7.9.7R, and by subsequent events, to which I will return later in this judgment.

7. – Upon what date are the clients' respective shares in the CMP to be calculated: the PPE or the date of distribution?

276. In Global Trader (No 2), David Richards J had no hesitation in concluding that the distribution rules required, as a matter of simple interpretation, the calculation and (if necessary) valuation of clients' shares as at the PPE. I have nonetheless been presented with a sustained argument that the distribution date (or, in practice, a date as near to actual distribution of the CMP as possible) constitutes a fairer basis for calculation, essentially because it automatically takes into account events occurring after the PPE which, it is suggested, ought in justice to have a consequence in terms of clients' shares. The types of event in question all arise by way of example from the failure of LBIE, but one or more or even all of them could arise upon the failure of many types of large or sophisticated firm, in particular if it carried on business internationally.

277. The events relied upon by Mr Howe (for GSIP) and by Mr Hubbard (for Paragon) are as follows.

Movements in exchange rates

278. A large part of GSIP's business with LBIE was, at least contractually, denominated in Japanese Yen, and a significant part of GSIP's client money was, prior to the PPE, actually segregated and held by LBIE in Yen.

279. The Yen has, since the PPE, appreciated substantially against the US dollar. Although the Administrators have retained the CMP as a multi-currency fund substantially as they found it upon appointment, the bulk of it has at all times been held in US dollars and the Administrators propose, unless directed otherwise, to calculate and make distributions in dollars.

280. If GSIP's client money entitlement pursuant to CASS7.9.6R(2) is calculated as at the PPE, and its contractual entitlement to Yen therefore converted into US dollars as at that date, two consequences will ensue. The first is that GSIP will be deprived of the benefit of the appreciation of its contractual currency as against the US dollar or, to put it the other way round, visited with the adverse consequence of the dollar's decline against the Yen. The second is that, since the Yen part of the CMP has itself appreciated against the dollar, this appreciation will be shared among all clients entitled to share in the CMP, rather than by GSIP and such other clients of LBIE with a contractual entitlement to Yen, or for whom LBIE segregated Yen prior to the PPE.

Post Administration gains in open positions

281. As I have already observed, it took some time following the PPE for all open positions in respect of which LBIE was the counterparty with the relevant clearing

houses to be closed by reason of LBIE's default. There was during that rolling closure period a general depreciation in the aggregate value of those positions. Nonetheless, some clients' positions, including those of GSIP, enjoyed a net gain during the closure period. GSIP's aggregate gains amounted to some US$28 million.

282. The effect of gains and losses in exchange traded, cash settled, margined positions following the PPE was generally to give rise to corresponding credits to and debits from LBIE's client transaction accounts, by then forming part of the CMP. Upon closure at a profit, the proceeds of a cash settled position would also be credited to the relevant client transaction account. Thus, in relation to GSIP for example, the relevant client transaction accounts would during the period following the PPE have been notionally credited with the US$28 million gain, although in fact the overall position of the client transaction accounts, taken as a whole, would have suffered a net debit broadly equivalent to the aggregate loss in value of open positions as between the PPE and their eventual closure. I describe the credits attributable to GSIP's gains as "notional", because, on any particular day, each relevant clearing house and intermediate broker with which the client transaction accounts were held would have aggregated all gains and losses affecting LBIE's open positions for all the clients for whom it dealt on that exchange, and adjusted the amount in the client transaction account by reference to the net movement in value. Since LBIE's positions taken in the aggregate declined in value overall, it is likely that, on any particular day, GSIP's gains were outweighed by other clients' losses, even on the same exchange.

283. If the open positions of all LBIE's clients are to be valued as at the PPE (consistent with the opinion of David Richards J in <u>Global Trader (No 2)</u>) subsequent gains and losses in different clients' positions will not fall to be taken into account in quantifying the clients' shares in the CMP. The gainers will receive no credit, and the losers will suffer no debit. Furthermore, from the perspective of a client such as Paragon, with no positions open as at the PPE, a valuation of claims as at that date will leave unaffected the aggregate losers on open positions, so that, viewed from the point of distribution, Paragon will, it is said, share unfairly in their misfortunes.

<u>Depot breaks</u>

284. These are described in SAF 2.16.5. They arise because, from time to time, LBIE held an insufficient number of securities to meet all of its clients' requirements, and in such circumstances LBIE segregated a sum in the client bank accounts equivalent to the shortfall, on a stock line basis, rather than by attributing the shortfall to any particular client or clients. As explained in SAF 2.51.3, depot breaks were on occasion resolved after the PPE so as to render the amount segregated in respect of them surplus to that requirement. Furthermore, additional depot breaks were found to have occurred, for which no money had been segregated.

285. The proponents of a distribution date for calculation submitted with some force that by postponing calculation until then, the extent to which depot breaks had been resolved could be ascertained with certainty, so that clients who had received securities as the result of the resolution of a depot break would not be rewarded, as it were, twice over, by receiving an additional amount from the CMP.

Fails

286. As appears from SAF paragraph 2.16.6, LBIE experienced occasional security shortfalls which led it to fail to make delivery of stock to a purchasing client who had paid for it, and typically segregated as client money for the disappointed client an amount equivalent to the value of the undelivered security. Again, as appears from SAF paragraph 2.50.3, further fails emerged, and other earlier fails were resolved by delivery, after the PPE. The choice of a distribution date for calculation of clients' shares would, it was submitted, ensure that no client received both the promised security, and an amount from the CMP attributable to the sum segregated in respect of earlier non-delivery.

287. It is not clear whether any of these, or other examples, were put before David Richards J when, at a non-adversarial hearing attended only by counsel for Global Trader's administrators, he decided that the PPE date was the mandatory date for calculation or valuation of clients' shares in the CMP. Taken together, or even singly, the examples to which I have referred do give serious pause for thought as to whether the choice of a PPE date produces a fair or just result.

288. The choice of any particular date for calculation of clients' shares in the CMP does not exactly leap from the pages of CASS7. It may well be that, anticipating an efficient and timely distribution of the CMP, the draftsman did not expect there to be any significant delay, or any consequential unfairness of significant magnitude, one way or the other. It may well be that when all the ambiguities and uncertainties in the interpretation and application of CASS7 have been sorted out (whether as a result of this judgment or on appeal), delays of the type which have adversely affected distribution of the CMP in this case will be very rare. Nonetheless, in volatile markets, even a short delay can have large consequences in terms of changes in value of open positions, so that this issue cannot simply be treated as a one-off historical anomaly.

289. It seems to me that there are, in theory at least, four alternatives by way of interpretation of CASS7. The first is that to be found in Global Trader (No 2), namely the PPE date. The second is the distribution date (or as near to distribution as may be practicable). The third is that CASS7 imposes no rigid date at all, leaving the choice of the appropriate date to the firm or other trustee of the CMP, subject to any direction by the court to the contrary in the event of dispute. The fourth alternative is that CASS7 proposes one or other of the dates contended for as a general rule, but permits departure from it in circumstances where its use would cause injustice. Needless to say, the proponents of the two alternative dates fell back upon alternatives three and four, but no-one advanced a flexible interpretation as their primary submission. My conclusions now follow.

290. The starting point must I think be that any *pari passu* distribution to the beneficiaries of a trust fund which is or may be in shortfall must proceed by way of a single date for calculation and, if necessary, valuation of competing entitlements. Otherwise those competing entitlements cannot fairly be rated as against each other. For a cogent explanation why that must be so: see Re Dynamics Corporation of America [1976] 1 WLR 757 at 764 d to f. This much was, or became, common ground.

291. Next, the concept of a *pari passu* distribution of a trust or other fund in shortfall is as old as the hills, and the issue as to the correct date for calculation or valuation of the claims of all those entitled has been worked out by the courts, and subsequently adopted in relation to the insolvency code by Parliament, over many years. A consensus that the date when the fund is first constituted for the purposes of *pari passu* distribution is the correct date is easy to discern. A convenient summary of how this occurred over time is to be found in Re Lines Brothers Ltd [1983] Ch 1, per Lawton LJ at page 14, and per Brightman LJ at pages 17 to 18, with whom Oliver LJ agreed. As is well known, Parliament subsequently adopted the date of the commencement of the winding up or the administration (as the case may be) as the appropriate date, at least for the conversion of foreign currency entitlements: see paragraph 2.86 of the Insolvency Rules 1986.

292. Notwithstanding the submissions of Mr Howe and Mr Hubbard to the contrary, there is in my judgment nothing to the point in the fact that for the purposes of converting a foreign currency claim in debt, the courts have subsequently adopted a later date: see Miliangos v. George Frank (Textiles) Ltd [1976] AC 443, or that for the purposes of the law of damages generally, the court has in recent years departed from a breach date rule in favour of a flexible approach to the identification of a date best calculated to give effect to the restitutionary principle: see for example County Personnel v. Pulver [1987] 1 WLR 916. In neither of those situations is there a requirement to calculate or value competing entitlements to share in a fund in shortfall, nor, therefore, any need to ascertain a fixed date, or a single currency, for a comparative valuation of all beneficiaries' shares.

293. The justification given in Re Lines Brothers for the adoption of the date upon which the fund is constituted for the purposes of *pari passu* distribution is that it is the earliest available date, and that the choice of the earliest date facilitates the prompt distribution of the fund: see per Lawton LJ at page 14E to F where he said, in connection with a creditors' voluntary liquidation:

> "Creditors' contractual rights to be paid by the company become under the statutory scheme a statutory right to a share in the trust fund. The size of this fund has to be ascertained as soon as possible because until it is ascertained it cannot be applied in satisfaction of the company's liabilities; and, as like has to be compared with like, the valuation of the fund has to be in sterling."

Or, as Brightman LJ put it, at page 18D to E:

> "But when is the property of the debtor company subjected to equal distribution among the creditors? At the date of the winding up order. Then, and not until then, is the company divested of its property. In effect, the property is handed over to the official liquidator to be broken up and distributed in proportionate parts among the creditor claimants who are entitled. Well, then, it follows immediately that the valuation must be made when the necessity for a valuation arises. The necessity arises, as I have said, when the order to wind up is

made; and that, therefore, becomes necessarily *the date of the valuation*."

294. In the present case, the necessity for the constitution of the CMP and its *pari passu* distribution among the clients entitled to share in it, arises as at the date of the PPE. By analogy, that is the date upon which any questions of calculation and valuation should, in accordance with settled law, be carried out, in the absence of any clear provision in the rules to the contrary.

295. An attempt was made by the opponents of the PPE date to distinguish cases such as Re Lines Brothers upon the basis that the CMP does not become for the first time a trust fund as at the PPE. Rather, it is the pooled aggregate of segregated money held on trust *ab initio*. In my judgment, that is a distinction without a relevant difference. The force of the reasoning in cases such as Re Lines Brothers is not that there is, prior to the valuation date, no trust fund, but that the valuation has to take place as soon as it becomes necessary, as a precondition to the *pari passu* distribution of the fund.

296. I start therefore with a predisposition to think that, if those responsible for CASS7 had wished to substitute some different or later date for the calculation and valuation of clients' shares from that earliest possible date sanctioned by long standing authority, they would have made this clear in the rules. On the contrary, as identified by David Richards J in Global Trader (No 2), such relevant indications as there are in CASS7 tend to support the PPE as the chosen date for calculation and valuation. His analysis, with which I respectfully agree, is set out at paragraphs 18 to 21 of Global Trader (No 2). It is clear that David Richards J had the Re Lines Brothers line of authority well in mind: see Re Telewest Communications plc (No 1) [2005] 1 BCLC 752, at page 765, in paragraph 35. To his analysis I would only add that CASS7.9.9R(2), which expressly contemplates that a calculation of the client money entitlement will be carried out as at the PPE, tends persuasively, albeit not conclusively, to support the same textual analysis.

297. I must however explain my reasons for rejecting at least the main submissions to the contrary. An important textual submission arose from the absence of any reference, either in CASS7.9.6R or in CASS7.7.2R (to which it refers) to interest earned on the CMP between the PPE and the date of distribution or, for that matter, to any gains made by the prudent investment of the CMP, pending distribution, by the firm or other trustee.

298. The force of this point is best illustrated by an example. Suppose that a firm failed with full segregation of client money, but that the distribution of the CMP was held up by difficulties in closing certain open positions, during a period of high interest rates and rising values in the market in which the open positions were held. As at the PPE the value of the CMP was sufficient to pay all clients in full. By the time of distribution, it had increased in value by 15%, but the distribution expenses amounted only to 1%. The 15% increase in value was attributable mainly to interest, but in part to gains in the value of the positions which had been open as at the PPE, and which were cash settled into client transaction accounts forming part of the CMP. To whom should the 14% net increase in the amount available for distribution since the PPE be paid, and in what proportions?

299. Four alternative solutions to this conundrum were canvassed during the hearing. The first, by Mr Peacock for the unsecured creditors, was that clients' entitlements crystallised as at the PPE, so that the whole of the 14% net surplus should be paid to the firm, pursuant to CASS7.7.2R(5).

300. The second, submitted by the proponents of a distribution date calculation, was that the clients could add interest to their claims against the CMP to the extent that their contracts with the firm permitted them to do so, while the investment gains on open positions would naturally accrue to the clients whose positions they were. The third, which I introduced as a possible solution to the potential injustice of the first, was that all clients' entitlements would, valued as at the PPE, be expressed as percentages of interest in the CMP, in an aggregate amounting to 100%, and then applied to the value of the CMP at the time of distribution. In that way, the clients would pick up any interest and investment gains in the CMP in the same proportions as their client money entitlements to the CMP as at the PPE.

301. The final alternative, advanced by the Administrators in reply, was that alternative three should be applied, but without any requirement that the aggregate of the clients' percentages of interest should be 100%. If the sum total of the clients' entitlements as at the PPE was less than the then value of the CMP, the difference between the two would constitute a percentage of interest to which the firm was entitled by way of surplus under CASS7.7.2R(5) so that when those percentages were applied to the CMP as at the distribution date, the interest and investment gains would be shared fairly between the clients and the firm, in proportion to their respective interests in the CMP as at the PPE.

302. I have no difficulty in rejecting the first alternative. I consider it obviously unjust that all the interest and investment gains on a fund largely (and in most cases probably exclusively) owned beneficially by clients should in any circumstances accrue for the benefit of the failed firm. Furthermore, since periods of high interest rates are commonly accompanied by periods of high inflation, the beneficiaries of the CMP would, if disentitled to any interest, suffer a corresponding fall in the real value of their own property, to the corresponding advantage of their trustee, even though the distribution rules made full provision under CASS7.7.2R(4) for deduction by the trustee of the costs of distribution.

303. The second solution, based upon a distribution date calculation of client money entitlement would, in the real world, only be slightly better. First, as the proponents of this alternative acknowledged during argument, contractual rights to interest on client money may be non-existent, vestigial or otherwise unsatisfactory, and the interest accruing on the fund may well exceed clients' contractual entitlements, and thereby still accrue to the firm under CASS7.7.2R(5). Furthermore, different clients may have differing contractual entitlements. While a nil or low rate of interest on client money may be a reasonable contractual bargain during the period when the firm is actively providing the specified investment services, it by no means follows that, after the firm's failure, those contractual provisions as to interest should limit the clients' entitlement to the actual return on their own money, while held in the CMP awaiting distribution, or discriminate between the entitlements of different clients to share in the return on the common fund.

304. I was eventually persuaded that alternative three is also wrong, because it would prevent there ever being a surplus upon distribution of the CMP, something which is expressly contemplated by the language of CASS7.7.2R(5), by its reference to subparagraph (4) which refers expressly to the failure of the firm, and to the costs of distribution as a deduction which may nonetheless leave a surplus.

305. The fourth alternative does not sit entirely comfortably with the language of CASS7.7.2R, which does not in terms contemplate the firm being recognised as having a percentage of interest in the CMP as at the PPE, but only an interest in the residue, after all client money entitlements and distribution costs have been met in full. Nonetheless it seems to me that with some adjustment to ensure that the costs of distribution are set against any percentage of interest of the firm before reducing distributions made to clients on account of their interests, alternative four represents much the most just, sensible and realistic solution to the difficulty.

306. In the present case of course, there is no question of a surplus. Interest rates are low, and the overall investment performance of open positions cash settled into the client transaction accounts has produced an aggregate loss. It is therefore unnecessary for me finally to resolve the conundrum presented by the absence of any reference in the distribution rules to the apportionment of interest and investment gains. The importance of the analysis is only that it shows that a distribution date for calculation and valuation of client money entitlements as the basis of sharing in the CMP is not the correct or obvious solution to the apparent lacuna, and that the absence of any reference to interest does not therefore assist the proponents of the distribution date case.

307. Nor do the other examples of potential injustice alleged to flow from the adoption of the PPE as the date for calculation survive detailed analysis as a basis for choosing the distribution date, either as the correct date as a matter of interpretation, or as an option to be applied in particular cases, including that of LBIE. A common feature of the submissions of all those who sought to rely upon those supposed injustices in support of the distribution date case was that they proffered alternative solutions to them if that primary case was not accepted. In my judgment, for reasons which I now explain, to the extent that the adoption of the PPE as the date for calculation and valuation has the potential to cause real rather than imagined injustice, those alternative solutions are to be preferred to the adoption of the distribution date, whether as a mandatory uniform date, or as one to which recourse can be had in particular cases.

308. I can take post Administration movements in exchange rates and gains in open positions together. Viewed from the point of view of the client with the appreciating currency and/or the positions which gained in value, the supposed injustice is that, while the effect of those market movements swells the CMP (via the holdings of foreign currency and the cash settlement of open positions into client transaction accounts), the gains do not accrue to the benefit of that client, but rather to the clients as a whole, while the clients whose currencies and positions have gained also share in the losses attributable to the currencies and open positions of other clients.

309. While I can understand a particular client's dismay in that regard (which was well presented by Mr Howe in particular), justice must be looked at from all perspectives, including those of the clients whose open positions (or currencies of account) have

depreciated. As Mr Zacaroli submitted, those clients are locked into the involuntary holding of depreciating positions and/or currencies due to the failure of the firm, in circumstances where they would otherwise have been free to close out their positions or convert their currencies earlier, so that there is no obvious justice in visiting solely upon them the poor performance of positions from which, but for the firm's failure, they could have extricated themselves.

310. In my judgment, the supposed injustices relied upon under these two headings are more imaginary than real. The effect of the distribution rules is that, upon the happening of a PPE, the previously separate fortunes and entitlements of clients, whether in relation to separate currencies or separate open positions, are pooled into a common fund, in the subsequent fortunes and misfortunes of which they all share rateably. True it is that, in form, the open positions are not themselves pooled, but where they relate to exchange traded cash settled margined transactions linked to client transaction accounts, the economic consequences of changes in their value are reflected in those accounts which, as from the PPE, form part of the common pool.

311. It is therefore to my mind entirely appropriate and just that gains and losses following the PPE, whether in currency or in open positions, the economic effects of which are reflected in changes in value of the CMP, are shared rateably among the clients in accordance with their respective entitlements calculated as at the PPE. Indeed, calculation as at that date is the precisely appropriate moment, because it is also the point in time at which their interests change from being separate to being interests in a common pool.

312. I must briefly mention an alternative solution propounded by Mr Howe in relation to open positions as at the PPE. Relying on the analysis of Lord Hoffmann in Wight v. Eckhardt Marine GmbH [2004] 1 AC 147, at paragraphs 29 to 33, he submitted that the valuation of positions open as at the PPE should, even if conducted as at that date, be carried out with the benefit of hindsight, applying the values obtained on closing as if they were the best evidence of the value of the same positions as at that earlier date.

313. My conclusion that a PPE valuation is the just application of the principle of pooled fortunes which underlies the distribution rules makes it unnecessary to consider this as a supposed solution to an imaginary injustice. Even if I were wrong however, I do not regard Wight v. Eckhardt as justifying the use of hindsight for the purposes of a retrospective valuation of an open margined exchange traded position. Lord Hoffmann's analysis was applied to a situation where claims which creditors appeared to have had against an insolvent bank had been, by the time of the adjudication of proofs in the liquidation, overtaken by a statutory scheme whereby the relevant assets and liabilities of the bank had been vested in a newly established bank. Applying an analysis previously used for the valuation of a contingent debt constituted by a policy of insurance on the life of a person living as at the date of the winding up order, Lord Hoffmann concluded that it was appropriate to take account of the fact that, by the time of adjudication of proof, the supposed creditor had turned out not to be a creditor at all.

314. That analysis is in my judgment far removed from issues as to the valuation of open exchange traded positions. It is an invariable characteristic of such positions that they are constantly marked to market, for example for the purpose of claiming or repaying

variation margin. While LBIE's PPE no doubt occurred between daily valuations of that type, such modest intra-day uncertainty as to the precise value of open positions at the precise moment in time when the Administration Order was made (which of course occurred at a different time in the business day in the numerous exchanges with which LBIE did business around the world) pale into insignificance compared with an artificial attempt to pretend, by reference to much later closing prices, that the open positions were in truth worth the amount for which they later closed. Accordingly, this submission is to be rejected.

315. The resolution of fails and depot breaks after the PPE calls for entirely different treatment. In such cases, the delivery to the client of securities discharges the primary contractual and/or fiduciary obligation of the firm, for which its earlier segregation of an amount of its own money was never intended to be more than a fallback, by way of security for the payment of money in lieu. It is to my mind obviously unjust that a client should be able to obtain both the security contracted for and the monetary payment segregated for him by way of precaution against a delivery failure which did not, in the event, occur. True it is that the security in question may have declined in value between the date when it should have been delivered and the date when the depot break or fail which prevented delivery was resolved. But in those circumstances it seems to me that the client's remedy lies in such contractual right (if any) as he may have to reject late delivery.

316. The solution to the injustice thus disclosed lies not in adopting a distribution date for calculation of client money entitlements, but in identifying the remedy to that injustice provided by the general law. The alternatives proposed in argument were first, that the client should give credit for the value of the security when delivered against his net share in the CMP (i.e. as reduced by the amount of any shortfall); secondly that the client should give credit for the same amount against his gross client money entitlement; thirdly that the client should give credit against his gross client money entitlement for the full amount segregated in respect of that depot break or fail; and finally that the firm should be subrogated to the client's claim to that part of the CMP distributed to him in respect of the relevant depot break or fail, since the firm had resolved the depot break or fail by purchasing the necessary securities from its own resources.

317. In my judgment the third of those alternatives is correct in principle. If a client elects to take securities proffered by way of resolution of a depot break or fail, that client must, in effect, give up that proportion (if any) of its client money entitlement which is represented by the amount (if any) previously segregated for him in respect of the non-delivery of that security. The consequence is that the client must set that amount against the gross value of his client money entitlement, not merely against any net distribution from the CMP after taking account of a shortfall. If a client whose security has fallen in value before the proffered late delivery has no contractual right to reject delivery, then the consequence is nonetheless the same. The client cannot at one and the same time receive the primary contractual entitlement in the form of the security, together with the amount (if any) segregated for him against the risk of its non-delivery. I say "if any" because it is not clear to me that segregation on a stock line basis in respect of a depot break does give rise to any increase in the client money entitlement of any particular client (see below).

318. The foregoing analysis sufficiently explains why I consider the first and second alternatives to be wrong. As for the fourth, I consider that it would create a claim of the firm against the CMP with a priority contrary to that set out in CASS7.7.2R. The proper application of the order of priorities there set out (described during the hearing as "the waterfall") is that any augmentation of the CMP caused by a client having to give credit against what would otherwise be its client money entitlement serves to fund distribution expenses and reduce shortfalls, at least until all clients have been paid in full.

319. The solution which I consider to be correct in principle should cause no difficulty in relation to fails, because LBIE segregated money against fails on a client by client basis. It will therefore always be possible to identify the proportion of any client's entitlement represented by an amount segregated for him against a fail.

320. The position is not so easy in relation to depot breaks, where LBIE segregated in relation to them on a stock line, rather than client by client basis: see SAF paragraph 2.16.5. Such segregation therefore served as security for an alternative monetary remedy for such clients as, in the event, would turn out not to obtain the contracted securities due to an aggregate shortfall in the firm's holdings of securities of the type in question. The result is that it is probably not possible to identify, merely by looking at the last internal reconciliation accounts, the clients for whom an amount was segregated against a depot break. Indeed, that form of segregation will be more like a prudential segregation of client money under CASS7.4.21R, which gives rise to no corresponding client money entitlement in favour of any particular client. It simply augments the CMP.

321. If that analysis is correct, then it seems to me that a client who receives securities as the result of a post PPE resolution of a depot break may have no specific part of his client money entitlement which is referable to the amount segregated, and against which he can therefore be required to give credit upon receipt of the security. On that analysis, there may be no injustice calling for a remedy by reference to the general law in allowing that client both to take the security and to pursue the whole of his client money entitlement, as disclosed by the last internal reconciliation accounts. Conversely, a client adversely affected by a depot break which is never resolved may be entitled to an equivalent upward adjustment in his gross client money entitlement, by way of a fair appropriation to him of the appropriate part of the amount segregated against the relevant depot break.

322. I acknowledge some uncertainty about the practical application to depot breaks of the principle which I have described, which was not fully explored at the hearing. I would therefore be disposed to hear further argument (or entertain further written submissions) on this limited point if the Administrators consider that my decision and reasoning on it leave them in any continuing difficulty.

323. Whatever the outcome of the application of that principle to depot breaks, it is in my judgment clear that neither those events nor fails constitute any good reason for departing from the PPE date for calculation and valuation of shares in the CMP, even though they may constitute, on a case by case basis, good reason for the making of subsequent adjustments.

324. I therefore consider that for reasons to be derived from an analysis of the distribution rules themselves, together with the principles to be found in the general law, the PPE rather than the date of distribution is the correct date for the calculation and (where necessary) valuation of clients' shares in the CMP. I do not consider that it is right to treat the date thus identified as merely a *prima facie* rule, subject to exceptions. To do so would introduce an undesirable element of uncertainty into a process which should be capable of being conducted in a timely and efficient manner. That uncertainty would also impede any realistic prospect for clients to hedge against the risks arising from the firm's failure. Furthermore, for the reasons which I have given at length, it seems to me that, having regard to the pooling of fortunes and misfortunes imposed by the distribution rules as at the PPE, that date is the only correct date for calculation and valuation.

8. – To what extent if at all can the firm's claims against its clients be set off against the clients' entitlements to share in the CMP

325. I was treated to a long and very learned debate about set-off, and to the citation of a large number of authorities. Set-off was advanced by Mr Peacock on behalf of LBIE's unsecured creditors as a means of recovering debts owed by clients to the firm, with a fallback based upon an alleged entitlement for LBIE to retain amounts which would otherwise have been distributed from the CMP, against payment of such debts. Set-off was also advanced by Mr Hubbard as a final fallback method of visiting upon clients with open positions as at the PPE the misfortunes occasioned by subsequent falls in value of those securities.

326. I have to say that both during the hearing and thereafter I have regarded the rarefied arguments about set-off as taking place in an atmosphere of considerable unreality, for a number of reasons. First, as between LBIE and its clients, many if not most of the standard forms of contract regulating their relationship conferred contractual rights upon LBIE to have recourse to client money by way of security for those clients' liabilities: see for example the charge IPBA which was the subject of intense scrutiny in the last application for directions by the Administrators before me: [2009] EWHC 2545 (Ch). Issues as to contractual entitlements are not the subject of this application, nor is it suggested that anything in CASS7 prohibits the firm from taking security over client money, with a client's agreement.

327. That atmosphere of unreality is intensified by the extreme improbability, upon the assumed facts, that recourse to set-off against clients with entitlements to share in the CMP would come anywhere near producing the surplus necessary for the outcome to be beneficial to LBIE's unsecured creditors. Finally, questions of set-off as between LBIE and its clients would matter only if the relevant clients were themselves insolvent, since otherwise it may be supposed that they would pay their separate debts to LBIE in full.

328. Secondly, as between clients with losing positions and other clients with shares in the CMP, I find it difficult to conceive what possible application set-off can have, in circumstances where neither have claims against each other. For reasons which I have given in detail in the previous section of this judgment, I need say nothing more about set-off as between different classes of client.

329. The general law supplies other means whereby the beneficiaries from the resolution of fails and (possibly) depot breaks may have to give credit against their client money entitlements, and the common sharing of the ups and downs in value of all assets within, or with commercial consequences which affect, the CMP leaves no room or necessity for recourse to be had to any further mechanism for adjustment. I have also concluded, at paragraph 269, that clients who received payment of client money entitlements from LBIE's house accounts between the PLS and the PPE must bring those receipts into account against the client money entitlements shown for them in the last internal client money reconciliation account carried out as at the PLS.

330. Returning to set-off as between LBIE and its clients, Mr Peacock's argument may be summarised as follows:

i) There is a sufficient mutuality between clients' claims against LBIE in respect of client money and LBIE's claims against clients, at least in relation to MiFID business, to qualify for either, or both, equitable and insolvency set-off.

ii) Although, as at the time of the hearing of this application, insolvency set-off had yet to be triggered by the giving of a notice of intention to distribute by the Administrators (see paragraph 2.85 of the Insolvency Rules 1986), the court should nonetheless apply insolvency set-off upon any distribution from the CMP prior to the giving of such a notice.

iii) Since the distribution rules contemplated that the firm would have possession of client money immediately prior to distributing it to any particular client, set-off could be applied as between the firm and the client at that moment.

iv) Alternatively, the firm could exercise a right of retainer against money about to be distributed to clients, so as to recoup itself, in effect by self-help, in respect of debts owed by the relevant client to the firm.

331. In my judgment set-off has no part whatsoever to play in relation to the distribution of money from the CMP to clients pursuant to CASS7.9. Any attempt to introduce set-off is founded on the fallacy that a client's proprietary right under the statutory trust to receive a share of the money held in the CMP is to be equated with a debtor/creditor relationship under which the client is the creditor and the firm is the debtor. It is in truth nothing of the kind. It is a trustee/beneficiary relationship in which the firm is the trustee (unless and until replaced as trustee of the CMP) and the client is the beneficiary. The client's claim is proprietary, that is, a claim *in rem* against all the world (other than equity's darling) in relation to the trust fund, not merely a personal claim against the trustee.

332. In <u>Guinness plc v. Saunders</u> [1988] BCLC 43, Mr Ward, a director of Guinness, held the sum of £5.2 million as a constructive trustee for the company, but claimed to be entitled to set off or retain a sufficient part of that sum to meet his cross-claim for remuneration from the company on the basis of a quantum meruit. At page 51g to h Browne-Wilkinson V-C said this:

> "In my judgment Mr Ward's cross-claims whether by way of quantum meruit or equitable compensation do not impugn Guinness' title to recover the £5.2 million. That money has at

> all times been Guinness' money. From the date of its receipt by or on behalf of Mr Ward, he has held it on a constructive trust for Guinness. Guinness is now entitled to a judgment to recover its own property. The fact that, arising out of the same transaction, Mr Ward may be entitled to remuneration for his services in no way impugns Guinness' right to recover its property from Mr Ward."

333. In the present case, the firm is (for as long as it is not removed) the trustee of the CMP under the statutory trust created by CASS7, which arises as from the original receipt of client money or other appropriation of the firm's own resources to meet a client money obligation, and the clients are the beneficiaries of that trust. The CMP constitutes a pooling of that trust property (or at least the segregated part of it) and is therefore a fund of which the clients are beneficial owners. The firm cannot impugn the clients' rights to recover their own property by the assertion of personal claims against clients, whether by set-off or, for that matter, by retainer.

334. The applicability of the principle enunciated by the Vice-Chancellor in Guinness v. Saunders to insolvency set-off is recognised in the second edition of Philip Wood's work on Set-Off and Netting, Derivatives, Clearing Systems, at paragraph 2-093, where it is stated as a general rule that:

> "Insolvency set-off is only available where there is a debtor-creditor relationship both ways, not where one of the parties has an in rem or proprietary claim for the restitution or delivery of its property."

335. As for Mr Peacock's alternative submission based upon a right to retain, I have already observed that it is inconsistent with Guinness v. Saunders. It would in any event be wholly contrary to the priority waterfall constituted by CASS7.7.2R, incorporated into the distribution rules by CASS7.9.6R(2). The waterfall creates a limited right for the firm (for as long as it remains trustee) to deduct its reasonable distribution expenses, and a right to any surplus, but that is all.

336. The unreality of the asserted right of set-off or retainer becomes even clearer once it is borne in mind that LBIE could be replaced as trustee of the CMP. The successor would of course enjoy the same right of retainer against its reasonable distribution expenses, but as Mr Peacock himself acknowledged, LBIE's supposed right of set-off or retainer against debts owed to it by clients would thereby inevitably be swept away.

337. That concludes my determination of the Main Issues raised by this application, and I can therefore turn to provide answers to the numerous specific questions raised by the Administrators.

THE ADMINISTRATORS' QUESTIONS

338. I shall address the detailed questions raised by this application one by one, setting out first, the question, secondly my answer to it and thirdly the reasons for that answer. For the most part the reasons will be sufficiently identified by reference to earlier parts of this Judgment, dealing with the Main Issues. Where necessary I will supplement them by reasons specific to the particular answer. The reason why the

numbering of the questions is not consecutive is that the Administrators concluded during the preparation and hearing of the application that the order set out in the final version of their list was more logical than the original order. Again, as with the SAF, I have transcribed the questions, but omitted all footnotes.

Constitution of the CMP

Which accounts?

Question

1. Does the term 'client bank account' include:

   (a) the core bank accounts in relation to which LBIE operated its client segregation system;

   (b) those bank accounts and money market deposits which were identified by LBIE's designation of the account as a client cash segregated account or alternatively were designated in LBIE's books and records as such and:

      (i) in relation to which LBIE complied with CASS 7.8.1R;

      (ii) in relation to which LBIE did not comply with CASS 7.8.1R;

   (c) a bank account other than an account falling within the description in (a) or (b) above which included only client money (whether or not LBIE appreciated this);

   (d) a bank account other than an account falling within the description in (a), (b) or (c) above which contains identifiable client money, and if so, to the extent of that identifiable client money, or to some other extent;

   (e) any other bank account, and if so, which account(s), and to what extent?

Answer

339. The term 'client bank account' includes the core bank accounts in subparagraph (a), but no other accounts. It does not therefore include the accounts identified in subparagraphs (b) to (e).

Reasons

340. The essential distinction in relation to bank accounts lies between segregated client bank accounts, limited to those which LBIE used for the operation of its client segregation system, and house accounts: see paragraph 197 above. It appears from SAF 2.20.2 that the "non-core client money bank accounts" which I assume are those intended to be identified by question 1(b) were operated by LBIE no differently from its ordinary house accounts. They are not segregated accounts, and therefore not client bank accounts for present purposes.

341. Question 1(c) appears to refer to an account not intended to be operated by LBIE as a segregated account but which, by accident, may have held only client money. This might include a house account in which, by coincidence, a retrospective analysis as at the PPE shows that it had been credited only with client money. It would not for that reason alone be a segregated account.

342. The accounts referred to in question 1(d) would include all those house accounts used under the alternative arrangement for the receipt of client money from time to time, and clearly fall outside the concept of segregated accounts.

Question

2. Do the answers to question 1 above change where the accounts in question are held not in LBIE's name but in the name of a nominee of LBIE?

Answer

343. The answers to question 1 above do not change in those circumstances.

Reasons

344. This is common ground.

Question

3. Does the term 'client transaction account' include:

(a) those accounts maintained by LBIE with an exchange, clearing house or intermediate broker, as the case may be, in respect of transactions in contingent liability investments undertaken by LBIE solely with or for its clients;

(aa) transaction accounts of clients maintained in LBIE's books, not being accounts maintained by LBIE with an exchange, clearing house or intermediate broker;

(b) any other account, and if so, which account(s)?

Answer

345. The term 'client transaction account' includes those identified in question 3(a) but not those identified in question 3(aa) or any other account. For the purposes of the accounts referred to in question 3(a) it matters not whether the transactions in respect of which LBIE maintained those accounts were entered into by LBIE expressly as agent for the clients concerned, or on a principal to principal basis for the purpose of entering into a position for the client at the client's request.

Reasons

346. The answers to question 3 became common ground during the course of the application, save in relation to client transaction accounts in respect of positions

opened by LBIE on a principal to principal basis. In that respect, an argument was advanced at a late stage on behalf of the unsecured creditors that money in client transaction accounts in respect of investments entered into by LBIE for clients, but on a principal to principal basis *vis-à-vis* the clearing house, was not client money.

347. I reject that submission. First, LBIE invariably used client money for the purposes of entering into and margining such investment positions. They were therefore wholly funded by clients, so that money credited to client transaction accounts in relation to them was client money. Secondly, any doubt which there might otherwise have been about the matter is in my judgment laid to rest by CASS7.5.1G. It is usually the rules of the relevant clearing house that require a firm such as LBIE to contract as principal, even though it is nonetheless in substance entering into a transaction for a client. Accordingly, CASS7.5.2R(1) applies, because the firm thereby allows a clearing house or intermediate broker to hold or control client money "for the purpose of a transaction for a *client* through or with that *person*": see CASS7.5.2R(1)(a).

Question

4. Does the reference to 'client money accounts' in CASS 7.9.6R(1) include:

(a) the client bank accounts that LBIE maintained as at the Time of Appointment;

(b) the client transaction accounts that LBIE maintained at the Time of Appointment;

(c) any other account, and, if so, which account or accounts, and to what extent?

Answer

348. The reference to client money accounts in CASS7.9.6R(1) includes the client bank accounts referred to in question 4(a) and the client transaction accounts referred to in question 4(b), but not any other accounts.

Reasons

349. It is common ground that the client money accounts include those identified in subparagraphs (a) and (b) of question 4. They were, as at the Time of Appointment (the PPE), the segregated accounts maintained by LBIE. The reasons why the phrase 'client money accounts' includes no other accounts are fully set out in paragraphs 166 to 197 above.

Question

4A. When LBIE was obliged to segregate money in respect of a debt due from LBIE to a client but failed to do so, does the client, without more, have a proprietary interest in a sum in the amount of the debt?

Answer

350. The client does not have a proprietary claim, in the absence of any relevant receipt of client money from, on behalf of or for that client, merely because LBIE was obliged,

but failed, to segregate a sum of money from its own resources in respect of a debt due to that client.

Reasons

351. My reasons for this conclusion are fully set out at paragraphs 142 to 143 above, and are consistent with the conclusions of Sir Andrew Park on this issue in Global Trader (No 1). Pending the appropriation of a sum of its own money by LBIE to meet a client money obligation, there is, in the absence of any relevant receipt by LBIE of client money, simply no property to which the statutory trust can rationally be attached.

Question

4B. When LBIE opens a back to back position on a principal to principal basis with a third party, and funds its margin obligation to the third party with money which had been paid to LBIE by its clients as margin for their positions with LBIE (and assuming that LIBE has not already reimbursed the client or otherwise segregated client money for the client in respect of such transaction):

(a) is the corresponding balance on a transaction account held at that third party in connection with that back to back position held on trust by LBIE for the client?

(b) is a payment received by LBIE from the third party from a transaction account held at the third party in connection with that back to back position held on trust by LBIE for the client?

Answer

352. The balances and payments received referred to in subparagraphs (a) and (b) are both held on trust by LBIE for the client.

Reasons

353. See paragraphs 346 to 347 above.

Question

5. If there are accounts containing client money which is not pooled pursuant to CASS 7.9.6R, is LBIE obliged to transfer any such identifiable client money held by it at the Time of Appointment to the client for whom it was held pursuant to CASS 7.7.2R(2) (subject to an appropriate deduction for costs in accordance with CASS 7.7.2R(4))?

Answer

354. The statutory trust created by CASS7.7.2R (including subparagraph (2)) does apply to identifiable client money held by LBIE at the Time of Appointment otherwise than in the segregated accounts which constitute the CMP. Accordingly, LBIE is obliged upon request (and subject to any relevant agreements with the client(s)) to transfer such client money as is identifiable in non-pooled accounts to the client or clients

entitled to it, even though the distribution rules in CASS7.9.6R and following do not apply to it.

Reasons

355. This is the trust money for which CASS7.9 provides no express distribution rules. Provided that it is identifiable in accordance with conventional tracing principles, it is payable upon request (and subject to any relevant agreements with the client(s)) to the clients entitled to it. Their entitlement as beneficiaries is nonetheless governed by CASS7.7.2R, so that the client's entitlement is subject to the reasonable cost of effecting the distribution of that money. The reasons why I have concluded that client money of this type is held on trust are set out at paragraphs 137 to 165 above, in relation to Main Issue 1. For my reasoning in relation to the recovery of this type of client money: see paragraphs 166 to 197 above.

Question

5A. Is the success of any proprietary claim founded on conventional equitable principles dependent upon (inter alia) the claimant establishing:

(a) the existence of a prior beneficial interest in money or property;

(b) the money (or some part of it in the case of its payment into a mixed fund) or property in question or any substitute property being acquired with the same still being identifiable?

Answer

356. The claimant to any proprietary interest in client money in a non-pooled account must, by reference to conventional equitable principles, establish both the existence of a prior beneficial interest in money or property, and that the money or property in question, or any substitute property acquired with the same, is still identifiable.

Reasons

357. See generally paragraphs 166 to 197 above. In practice, a client will readily be able to establish a prior beneficial interest in any client money received by LBIE either from, for, or on behalf of him, because the statutory trust created by CASS7.7.2R applies from the moment of such receipt: see Main Issue 1. Nonetheless the client will have to apply conventional tracing principles in order to identify property (including non-pooled money in house accounts) to which his beneficial interest still attaches as at the date of the PPE. If he can identify a mixed fund which, in accordance with those principles, still contains his property, then he may be able to appropriate a part of that mixed fund to his beneficial interest in it, by means of an equitable charge.

Question

5B. In connection with Issue 5A, is the burden on the client to prove:

(a) in which money or property the client has a beneficial interest; or

(b) to which money or property an equitable charge attaches?

Answer

358. In both the respects contemplated by subparagraphs (a) and (b), the burden of proof is on the clients. That is however no reason why the Administrators should not cooperate with clients in connection with their reasonable endeavours to discharge that burden.

Reasons

359. See paragraphs 190 to 191 above.

Question

5C. In connection with Issue 5A, is it sufficient for the purposes of establishing a prior beneficial interest for the client to establish that LBIE was obliged to segregate money in respect of a debt due to that client but had failed to do so?

Answer

360. A failure by LBIE to appropriate property of its own in satisfaction of a client money obligation is not by itself sufficient for the purposes of establishing a prior beneficial interest.

Reasons

361. See paragraphs 142 to 143 above. This seems to me to be largely a repetition of question 4A.

Question

6. Is money which was due to LBIE or which LBIE would have been entitled to withdraw from the CMP at the Time of Appointment and which would, in the ordinary course, have been swept into LBIE's house accounts during a daily reconciliation in due course, had the administration not intervened, notionally pooled pursuant to CASS 7.9.6R or should it be excluded from the notional pooling?

Answer

362. Money of the type referred to in this question is notionally pooled pursuant to CASS7.9.6R.

Reasons

363. As appears from paragraphs 91 to 93 above, money due to LBIE (or which LBIE would have been entitled to withdraw from the CMP at the Time of Appointment) remains nonetheless client money until actually paid out: see CASS7.2.15R(4) and (5). In the event that the underlying reason for LBIE's entitlement is that it had, since

the PLS, paid money from house accounts to clients, then the clients concerned will have to give credit for those receipts against what would otherwise have been their client money entitlements to share in the CMP: see paragraphs 268 to 269 above. By contrast the money which LBIE thereby became entitled to, but did not, withdraw from the segregated accounts will remain in the CMP so as to reduce any shortfall, to pay expenses or (in the wholly unlikely event of a surplus) to be repaid to LBIE under the system of priorities constituted by the waterfall in CASS7.7.2R: see my answer to question 9 below.

Adjustment of the CMP

Adjustments in respect of events occurring prior to the Time of Appointment

Question

8. Is LBIE required to adjust the CMP (whether by way of segregating funds standing to the credit of LBIE's general accounts or by transferring sums from the CMP to LBIE's general accounts) to take account of:-

   (a) movements in the notional value of margined transactions between the close of business on 11 September 2008 (by reference to which LBIE conducted its final daily reconciliation exercise prior to the Time of Appointment) and the Time of Appointment; and/or

   (b) a client's equity balance as at the Time of Appointment, in circumstances where LBIE had previously wrongly not segregated any client money for the client?

Answer

364. LBIE is not required (or entitled) to adjust the CMP to take account of any of the matters referred to in this question.

Reasons

365. See paragraphs 199 to 226 above. In this respect I have reached the opposite conclusion from that reached by Sir Andrew Park in Global Trader (No 1), in relation to subparagraph (a), but not (b).

Question

9. Save as required by the answer to question 8 above, is LBIE not now required to adjust the CMP (whether by way of segregating funds standing to the credit of LBIE's general accounts or by transferring sums from the CMP to LBIE's general accounts) to take account of events between the close of business on 11 September 2008 (by reference to which LBIE conducted its final daily reconciliation exercise prior to the Time of Appointment) and the Time of Appointment which, in the ordinary course absent administration, would have led to an adjustment by LBIE of the amount of money segregated by it as client money?

Answer

366. LBIE is neither required nor entitled to adjust the CMP by reference to any of the matters referred to in this question.

Reasons

367. See paragraphs 199 to 226 above. This question is, for the most part, on all fours with Main Issue 5, save that it extends beyond topping up to what may be described as rounding down. Most of the reasoning which prohibits topping up applies equally to rounding down, save for the infringement of the insolvency code. In particular, my conclusion that, as at the PPE, the client money rules are replaced by the distribution rules, prevents any subsequent adjustment to the segregated funds by reference to any discrepancy thrown up by an internal reconciliation as at the date of the PPE. Furthermore, the statutory trust governing the CMP does not permit the firm to take anything out of it, once constituted, otherwise than strictly in accordance with the waterfall of priorities set out in CASS7.7.2R. Such money as, had the PPE not intervened, LBIE might otherwise have withdrawn from the segregated accounts remains available as part of the CMP to meet shortfalls and distribution expenses.

Question

10. Save as required by the answers to questions 8 and/or 9 above, is LBIE not now required to adjust the CMP to take account of any money which, prior to administration, LBIE should already have segregated as client money but had not?

Answer

368. LBIE is not now required to adjust the CMP to take account of any prior failure to segregate.

Reasons

369. See paragraphs 199 to 226 above. This is a central aspect of the Main Issue 5.

Question

10A. In relation to any payments which LBIE is required to make into the CMP pursuant to the answers to questions 8 and/or 9 and/or 10 above:

(a) is the payment payable as an expense of LBIE's administration within the meaning of Rule 2.67(1)(a) or Rule 2.67(1)(f) of the Insolvency Rules 1986 and, if so, which Rule;

(b) is any payment LBIE is obliged to make:

(i) subject to CASS 7.9.6R(1);

(ii) to be paid to the client for whom the money should have been held pursuant to CASS (subject to an appropriate deduction for costs in accordance with CASS 7.7.2R(4))?

Answer

370. In the light of my answers to questions 8, 9, and 10 above, this question does not arise.

Question

7. If the answer to question 6 or 8 or 9 above is that such money should be excluded from the notional pooling or removed from the CMP:-

(a) is the amount which may be withdrawn from the client money accounts on account of such sums:

(i) the full amount of the money;

(ii) the traceable amount (if any) of such money; or

(iii) a pro-rata proportion (taking into account any shortfall in the CMP), and, if so, of the entire amount, of the traceable amount, or of some other amount; or

(iv) some other amount and, if so, what amount; and

(b) is LBIE obliged or permitted to transfer the sum or sums established by the answers to question 70 above from the client money account in which it is at present held to a general account of LBIE (such that such sums become available to the general estate)?

Answer

371. In the light of my answers to questions 6, 8 and 9, this question does not arise either.

Adjustments in respect of events since the Time of Appointment

Question

11. Is LBIE not now required to adjust the CMP or to segregate further funds to take account of any events (including fluctuations in rates of exchange between the currency in which client money is held and the currency of receipt (or LBIE's liability, if different)) occurring since the Time of Appointment which, absent administration, would otherwise have led to an adjustment by LBIE of the client money segregated by it?

Answer

372. LBIE is not required or entitled to make any adjustment to the CMP by reason of events occurring since the Time of Appointment even though, but for the PPE, it might have done so in the ordinary course of business.

Reasons

373. The CMP consists purely of client money, in respect of which LBIE's only obligation (while it remains a trustee) is to distribute, and its only right is to payment of reasonable distribution expenses, and to any surplus pursuant to CASS7.7.2R(5). My conclusion that those parts of the client money rules calling for adjustment to the segregated accounts ceased to apply as at the PPE fortifies this analysis. This

conclusion is wholly without prejudice to LBIE's continuing contractual liabilities to its clients, which are not part of the subject matter of this application.

Question

12. In relation to any payments which LBIE is required to make into the CMP pursuant to the answers to question 11 above:

(a) is the payment payable as an expense of LBIE's administration within the meaning of Rule 2.67(1)(a) or Rule 2.67(1)(f) of the Insolvency Rules 1986 and, if so, which Rule;

(b) is any payment LBIE is obliged to make:

(i) subject to CASS 7.9.6R(1);

(ii) to be paid to the client for whom the money should have been held pursuant to CASS (subject to an appropriate deduction for costs in accordance with CASS 7.7.2R(4))?

Answer

374. My answer to question 11 means that the matters raised in question 12 do not arise.

Question

12A. If the answer to question 11 above is that money should be transferred from the CMP:

(a) is the amount which may be withdrawn from the client money accounts on account of such sums:

(i) the full amount of the money;

(ii) the traceable amount (if any) of such money; or

(iii) a pro-rata proportion (taking into account any shortfall in the CMP), and, if so, of the entire amount, of the traceable amount, or of some other amount; or

(b) some other amount and, if so, what amount; and

(c) is LBIE obliged or permitted to transfer the sum or sums established by the answers to question 110 above from the client money account in which it is at present held to a general account of LBIE (such that such sums become available to the general estate)?

Answer

375. In the light of my answer to question 11, the matters raised by this question do not arise either.

Primary and secondary pooling

Question

11A. Is the firm obliged ahead of the unsecured creditors to make good the shortfall arising from what would, but for CASS 7.9.13R, have been a secondary pooling event within CASS 7.9.14R ("the secondary pooling event"), and does that, in turn, depend on:-

(a) whether the secondary pooling event occurred before or after the primary pooling event; or

(b) whether the firm had failed to exercise due diligence in connection with the transfer of client money held by the firm to a third party pursuant to CASS 7.4.1R(1) to CASS 7.4.1R(2) or CASS 7.5.2R?

Answer

376. In the present case, the secondary pooling event occurred after the PPE constituted by LBIE's going into Administration. On those facts, the firm is not obliged, in derogation of the rights of its unsecured creditors under the insolvency code triggered by the Administration Order, to make good any shortfall arising in the CMP by reason of the secondary pooling event constituted by the Bankhaus failure. The question whether LBIE would, prior to going into Administration, have been obliged to top up its segregated accounts by reason of the earlier happening of a secondary pooling event does not arise on the facts, and is therefore a hypothetical question which need not be answered on this application. Nonetheless, in such an event I would not have regarded CASS7 as imposing a strict liability on LBIE to make such a payment to its segregated accounts. Its liability would have depended, *inter alia*, upon questions of the type referred to in subparagraph (b).

Reasons

377. Since the PPE occurred in the present case before the secondary pooling event constituted by the Bankhaus failure, the provisions of CASS7.9 relating to a secondary pooling event are thereby disapplied: see CASS 7.9.13R. Furthermore, even if a secondary pooling event precedes a primary pooling event, CASS7.9.13R nonetheless still provides that the pooling and distribution rules applicable to a primary pooling event then take over. Beyond that, it seems to me unnecessary to delve into hypothetical questions arising from that counterfactual order of events.

378. CASS7 imposes obligations upon a firm in relation to both the selection and monitoring of a bank at which it opens a client bank account. It imposes no strict liability on a firm to make good consequential shortfalls in its segregated accounts, still less in the CMP, but it may incur both contractual and tortious liability (for breach of statutory duty) to clients adversely affected by the combination of a failure to carry out those duties, and a consequent failure of the bank at which relevant client bank accounts are held.

379. All those obligations and liabilities would be personal liabilities of the firm to one or more of its clients, in respect of which the clients would not have any proprietary claim, and which could not be prioritised ahead of the firm's other personal liabilities, once subject to the insolvency code. Were the position otherwise, those clients injured by any such breach of contract or duty on the part of the firm would be improperly preferred to its general unsecured creditors.

Question

11B. Second, if the firm is not obliged to make good the shortfall ahead of unsecured creditors, do the clients affected by the shortfall have personal claims against the firm for the shortfall, or does that depend on whether the firm had failed to exercise due diligence in connection with the transfer of client money held by the firm to a third party pursuant to CASS 7.4.1R(1) to CASS 7.4.1R(2) or CASS 7.5.2R?

Answer

380. The personal claims against the firm in respect of damage caused to clients arising out of the failure of a bank at which the firm had deposited client money will depend upon the terms of the clients' contracts with the firm and upon the question whether the clients can establish any relevant breach of statutory duty by the firm, including its duties in connection with the choice and monitoring of client account banks, to the extent that a breach of those duties constituted a cause of the clients' loss.

Reasons

381. This analysis stems from my answers to the previous question. I consider that it would be inappropriate to delve any deeper into the precise nature, still less merits, of any causes of action which clients may have against LBIE personally in respect of the Bankhaus failure. The necessary factual basis for any such analysis is wholly lacking.

Existence and scope of client money entitlement

Question

15. Does a client for whom LBIE should have held client money on a segregated basis have a client money entitlement in relation to:-

(a) a position or instrument in respect of which there is client money in the CMP as constituted according to the directions given by the Court on this Application;

(b) a position or instrument in respect of which there is no client money in the CMP as constituted according to the directions given by the Court on this Application and in relation to which LBIE has at no time held client money on a segregated basis;

(c) a position or instrument in respect of which there is no client money in the CMP as constituted according to the directions given in relation to Issues 1 to 4 above but in relation to which LBIE at one time held client money on a segregated basis?

Answer

382. A client for whom LBIE should have held client money on a segregated basis has a client money entitlement in relation to the positions or instruments identified in subparagraph (a), but not in relation to the positions or instruments identified in subparagraphs (b) or (c).

Reasons

383. This question is, as I see it, designed to raise three issues. The first is whether a client money entitlement to share in the CMP depends upon a claims or contributions basis. This is the question which I decided in favour of the contributions basis: see Main Issue 6, and paragraphs 227 to 275 above.

384. The second issue, sometimes described as the "piggy back" issue, is whether a client for whom client money has been segregated in relation to one or more of his positions or instruments, may claim also in relation to positions or instruments of his in respect of which no client money was segregated. No respondent to the application was found prepared to argue a piggy back case, so Mr Milligan ran it on behalf of the Administrators, with becoming brevity and an appropriate lack of enthusiasm. In my judgment a partially segregated client is in no better position, *vis-à-vis* the positions or instruments in respect of which he was un-segregated, than a wholly un-segregated client.

385. The third issue relates to the de-segregated client, that is to a client whose position or instrument was originally the subject of an appropriate segregation of client money, but whose client money was then wrongly de-segregated by the firm. Again, in the absence of any respondent with an interest in advancing an argument that de-segregated clients should be in a better position than if they had not been segregated in the first place, this argument was pursued by Mr Milligan on behalf of the Administrators. He sought to rely upon paragraphs 103, 105 and 112 of <u>Global Trader No</u> 1, which related to a sum of just under £0.5 million which Global Trader by mistake paid out of its segregated accounts, in respect of a liability which it should have discharged out of its house accounts. An attempt shortly before Global Trader's administration to put right that mistake was incomplete by the time of the administration order, and Sir Andrew Park concluded that the clients entitled to share in the segregated accounts had to bear the loss pro rata to their client money entitlements to share in the CMP.

386. The answer to question 15(c) depends in my judgment upon whether the wrongful de-segregation by the firm of the money previously segregated in respect of the relevant position or instrument was accompanied by a corresponding debit in the firm's accounts against the client money entitlement of the client in question. The formulation of question 15(c) assumes that such a debit would have been made. Otherwise the wrongful de-segregation would merely create a shortfall in the segregated fund without any corresponding adjustment in the accounts to the particular client's client money entitlement. He would remain a segregated client just as before, but, like all the other clients, in relation to a segregated fund with a shortfall in it.

387. In <u>Global Trader</u>, the £500,000 odd was simply taken from the segregated accounts by mistake, without any corresponding debit to the client money entitlement of the particular client in question. Accordingly, Sir Andrew Park's analysis in relation to that payment affords no authority for treating a de-segregated client of the type contemplated by question 15(c) any differently from an un-segregated or under-segregated client. By debiting that client's client money entitlement in its reconciliation accounts, the firm would, albeit in breach of trust, be removing from the segregated funds the contribution previously made on his behalf. If the wrongful

removal occurred sufficiently near to the time of the PPE, it is possible that the relevant client might establish some tracing claim in relation to it, but he would have no entitlement in respect of it in relation to the CMP.

Question

16. Does a client for whom LBIE was neither required nor had agreed to hold client money on a segregated basis but for whom LBIE had segregated money in its client money accounts at the Time of Appointment have a client money entitlement in relation to:-

(a) a position or instrument in respect of which there is money in the CMP as constituted according to the directions given by the Court on this Application;

(b) a position or instrument in respect of which there is no money in the CMP as constituted according to the directions given by the Court on this Application and in relation to which LBIE has at no time held client money on a segregated basis;

(c) a position or instrument in respect of which there is no money in the CMP as constituted according to the directions given in relation to Issues 1 to 4 above but in relation to which LBIE at one time held client money on a segregated basis.

Answer

388. A client for whom, without obligation or agreement, LBIE had segregated money in its client money accounts by the Time of Appointment has a client money entitlement in relation to positions or instruments referred to in subparagraph (a), but not in relation to positions or instruments referred to in subparagraphs (b) and (c).

Reasons

389. This question raises the issue of over-segregated clients and, consistently with question 15, proceeds on a basis of looking at the client's rights, position by position. My negative answers to subparagraphs (b) and (c) of question 15 must lead, *a fortiori*, to the same negative answers to subparagraphs (b) and (c) of this question. More difficult is subparagraph (a). It contemplates a situation where, as at the PPE, the last internal reconciliation accounts of the firm identified, albeit it wrongly, a client money entitlement for a particular client, in respect of which the firm had segregated an equivalent sum. It had therefore, voluntarily and by mistake, declared itself a trustee under the statutory trust of that part of its segregated funds for the benefit of that client. I consider that it follows that the client must have a proprietary claim as against the CMP, although it may be that the firm will have a restitutionary claim for the recovery of that property (whether the beneficial interest itself or any money paid in satisfaction of it under the distribution rules), as money paid by mistake. It is no part of this application for me to delve into the merits of such restitutionary claims as there may be. The factual basis for that analysis is entirely lacking.

Question

16A. If the client for whom the money was segregated does not have a client money entitlement in respect of it, what is the client's right?

(a) Is the money held on trust for him outside the CMP or is the money part of the CMP?

(b) If money is held on trust for him outside of the CMP, is the client entitled to payment in the full amount of the money segregated for him?

(c) If the money forms part of the CMP, does the client have a proprietary interest in, and is he entitled to receive a distribution from, the CMP and, if so, how should the Administrators give effect to that interest? In particular, does the client share in the shortfall on the CMP? Or does the client have no more than a personal claim in debt?

Answer

390. In the light of my answer to question 16, this issue does not arise.

Reasons

391. I assume that the phrase "for whom the money was segregated" means segregated as at the time of the PPE. If question 16A is also intended to be a reference to the position of a wrongfully de-segregated client, I have dealt with that client's possible proprietary tracing claim in my answer to question 15(c).

Question

20. Does a client for whom LBIE should have held client money on a segregated basis but did not in respect of that client's proprietary positions, but for whose underlying clients LBIE did hold client money on a segregated basis, have a client money entitlement in respect of its proprietary positions?

Answer

392. A client of the kind contemplated by question 20 does not have a client money entitlement in respect of its own proprietary positions, merely because LBIE held client money on a segregated basis for one or more of that client's underlying clients.

Reasons

393. In the light of my answers to question 15, in relation to partially segregated clients, the negative answer to this question must be *a fortiori*. It is, as it seems to me, an even weaker version of the piggy back argument.

Calculation of client money entitlements

Question

21. Is LBIE obliged to calculate client money entitlements as at the Time of Appointment, and, if not, at what time should client money entitlements be calculated?

Answer

394. LBIE is obliged to calculate client money entitlements (that is entitlements to share in the CMP) as at the Time of Appointment.

Reasons

395. This question replicates Main Issue 7: see paragraphs 276 to 324 above. In their opening written submissions, the Administrators referred to certain difficulties in a calculation at the precise Time of Appointment, because of perceived difficulties in ascertaining the precise values of open positions in relation to a moment occurring during, rather than at the beginning or end of, a business day in certain time zones in which LBIE carried on its business. While I recognise those difficulties, they do not strike me as being in any way insurmountable, nor as requiring the choice of the beginning or end of a relevant business day, in preference to the moment when the Administration Order was made. In time zones where that occurred while a market was trading, it seems to me inherently likely that by some reasonable process of interpolation between opening and closing prices on that day, an appropriate valuation can be arrived at.

Question

22. Is LBIE permitted to calculate client money entitlements (and consequently the rateable share to which each client entitled to a distribution from the CMP is entitled) in a common currency of its choice, by applying a spot exchange rate as at close of business on the date of administration or alternatively at the Time of Appointment?

Answer

396. The Administrators must calculate client money entitlements (in terms of shares in the CMP) in a common currency. The Administrators are in principle entitled to identify an appropriate common currency, subject to any direction by the court that a particular chosen currency is inappropriate. They should convert all different currencies of entitlement to the common currency at the spot rate prevailing as at the Time of Appointment. If necessary, where no published spot rate is available as at that moment, they must do so by interpolation from the most appropriate proximate spot rates.

Reasons

397. The authorities to which I have referred in paragraphs 290 to 296 above demonstrate that the basis for *pari passu* sharing in a common fund can only be ascertained in monetary terms by reference to a common currency. Since the process of distributing the CMP in this case is not governed by the insolvency code (which requires the use of sterling) there is no reason why sterling should be used as the common currency. From the information available to me, it looks as if the Administrators would be justified in choosing the US dollar as the appropriate currency, being the currency in which LBIE transacted the bulk of its segregation processes as at the PPE.

Question

23. Is the client money entitlement of a client entitled to a distribution from the CMP calculated by reference to or affected by the amount in fact contained in the notional CMP in respect of him at the Time of Appointment and/or subsequently transferred to the CMP as required by the answers to the questions above? If so, what is the client money entitlement of a client in respect of whom there is no client money contained in the notional CMP at the Time of Appointment or subsequently transferred to the CMP as required by the answers to the questions above?

Answer

398. The client money entitlement of a client to share in the CMP needs to be calculated by reference to the amount in fact contained in the CMP in respect of him as at the Time of Appointment. That amount will generally be apparent from LBIE's last internal client money reconciliation carried out as at the PLS. Subject to one exception, a client for whom no money was shown in that reconciliation as contained in the segregated accounts, and therefore in the notional CMP as at the Time of Appointment, has no client money entitlement.

399. The exception consists of clients with open positions for whom, although no credit in a client transaction account was attributable as at the PLS, acquired a credit by virtue of an increase in the value of their open positions by the time of the PPE, with a consequential automatic adjustment of the relevant client transaction account.

Reasons

400. My answer, subject to the exception in the foregoing paragraph, derives from my analysis of the contributions basis of entitlement set out at paragraphs 227 to 275 above.

401. The exception arises from the self-adjusting nature of client transaction accounts, in respect of which a client with no client money entitlement as at the PLS might at least in theory acquire one during the period from then until the PPE. This would lead to an automatic contribution on his behalf to the relevant client transaction account, in which he should in principle be entitled to share.

402. It may be that the entitlements of clients to share in the CMP by reference to their contribution to client transaction accounts will not appear in LBIE's last internal client money reconciliation. This is because, as I understand it, the self-adjusting nature of client transaction accounts took place separately from the main process of reconciliation and re-segregation conducted by LBIE in relation to its core client bank accounts. If so, it has not been suggested that this leads to any insuperable difficulty in the identification of client money entitlements arising from open exchange-traded positions as at the PPE. My answer to this question should be understood in that light.

Question

23A. How is each client's client money entitlement (as referred to in CASS 7.9.6R) to be calculated? In particular, is it to be calculated, for each client, as:-

(a) the aggregate of (i) in the case of the core bank accounts, the amount which represented the funds in fact segregated for or on behalf of that client immediately following the Point of Last Segregation; and (ii) in the case of any other client money account (as determined in accordance with Q1-4 above), the amount which represented the funds standing to the credit, or paid into, the account on behalf of that client as at the Time of Appointment, in each case including any adjustment to the CMP as required by the answer to the questions above; or

(b) the amount which would have been segregated (or otherwise held in a client bank account determined in accordance with Q1-4 above) for or on behalf of that client if a calculation of the amount which LBIE was required to hold as client money for on behalf of that client had taken place as at the Time of Appointment; or

(c) the amount which would or ought to have been segregated for that client if a calculation of the amount which LBIE was required to hold as client money for that client had taken place as at the Time of Appointment as though all such client's open positions at that time had been liquidated and closed at the closing or settlement prices published by the relevant exchange or other appropriate pricing source at the Time of Appointment; or

(d) on some other, and if so what, basis?

Answer

403. Each client's money entitlement (as referred to in CASS7.9.6R) is to be calculated on the contributions basis set out in paragraphs 227 to 275 of this Judgment.

404. In particular, it is to be calculated in accordance with the method proposed in subparagraph (a) of this question, in relation to the core bank accounts but, in the light of my answer to question 1, there are no other relevant client bank accounts. The calculation will also take into account attributable credits in the client transaction accounts. No adjustments to the CMP are required or permitted. Clients will be required to give credit for receipts in respect of client money entitlements from the firm's house accounts between the PLS and the PPE, and in respect of certain other post PLS events, such as pre PLS fails which have since then been resolved. There may have to be a downward adjustment pursuant to CASS7.9.7R: see question 23B below.

Reasons

405. It will be apparent from earlier in this Judgment that I have specifically rejected the alternative methods proposed in subparagraphs (b) and (c) of this question. See generally paragraphs 227 to 275 above.

Question

23B. How, if at all, do the provisions of CASS 7.9.7R affect the calculation of client money entitlement in accordance with CASS 7.9.6R?

Answer

406. The provisions of CASS7.9.7R affect the calculation of client money entitlement by way of a reducing mechanism as described in paragraphs 255 to 262 of this Judgment. In short, CASS7.9.7R requires the client money entitlements for sharing in the CMP to be recalculated downwards if, but only if, LBIE did not avail itself prior to the PPE of the Reduced client money requirement option conferred by paragraphs 18 and 19 of Annex 1. If by contrast LBIE did avail itself of the Reduced client money requirement option, then no adjustment pursuant to CASS7.9.7R will be necessary.

Reasons

407. This issue is fully analysed at paragraphs 255 to 262 above.

Question

23C. (a) What is the individual client balance to which CASS 7.9.7R refers?

(i) Is it the individual client balance defined at paragraph 6(1)(a) of Annex 1?

(ii) If not, what is it?

(b) If it is the individual client balance defined at paragraph 6(1)(a) of Annex 1, is it subject to paragraph 12(2)? If so, is the debt to which paragraph 12(2) refers any debt or is it confined to debts arising in the course of MiFID business?

(c) If such a debt is not to be taken into account in the calculation of individual client balance should the debt nevertheless be taken into account by way of set-off or retention (see Issues 23D to F below)?

Answer

408. (a) The individual client balance is that defined at paragraph 6(1)(a) of Annex 1.

(b) It is not subject to paragraph 12(2) of Annex 1.

(c) The debt to which paragraph 12(2) refers should not be set-off against the client's client money entitlement against the CMP, nor should an amount equivalent to that debt be retained by LBIE.

Reasons

409. The answers to subparagraphs (a) and (b) appear to be largely common ground, in the light of helpful written submissions upon this additional question, and the useful table of those submissions prepared by the Administrators. In any event, the answers which I have given appear to me to flow inescapably from the language of Annex 1.

410. My conclusion that there should be no set-off is sufficiently explained in my analysis of Main Issue 8, at paragraphs 325 to 335 above.

Question

23D. To what extent, and at whose behest, can a debt owed by a client with a client money entitlement to LBIE be set-off against that client's claim against the CMP or an amount equivalent to that debt be retained by LBIE?

Answer

411. There can be no set-off or retainer in relation to claims by clients to a share in the CMP in respect of debts owed by the client to LBIE.

Reasons

412. Again, my reasons for this conclusion are set out in answer to Main Issue 8, at paragraphs 325 to 335 above. LBIE's only right of retainer is in relation to its reasonable costs of conducting the distribution from the CMP, and to any surplus, pursuant to CASS7.7.2R(4) and (5).

Question

23E. Does the set-off or retention operate between the debt and:-

(a) the client's total claim against LBIE;

(b) the client's client money entitlement;

(c) the amount of the client's distribution from the CMP;

(d) some other sum, and, if so, what?

23F. Should the sum so set-off or retained:-

(a) be distributed amongst those clients with a client money entitlement;

(b) accrue to the benefit of the General Estate; or

(c) be held by LBIE and not distributed by the Administrators pending the application of IR 2.85, IR 4.90 or further order of the Court?

Answer

413. In the light of my answer to question 23D, these two questions do not arise.

Question

13. Should LBIE recalculate a client's client money entitlement by reference to, or take into account in calculating the amount to be distributed to a particular client, events occurring since the Time of Appointment which, absent administration, would otherwise have led to an adjustment by LBIE of the client money segregated by it?

Answer

414. In the general terms in which this question is asked, the answer is no. Nonetheless, specific adjustments are required in relations to fails and may be required in relation to depot breaks.

Reasons

415. See generally Main Issue 7 and paragraphs 276 to 324 above. A general obligation to recalculate a client money entitlement by reference to all those matters which, absent administration, would have led to adjustments to the segregated funds in relation to post administration events would be to resurrect a distribution date basis for calculation and valuation.

416. Nonetheless, for reasons set out in paragraphs 317 to 319 above, specific adjustments will need to be made so as to require clients for whom fails have been resolved to give credit against their gross client money entitlement in respect of the amount segregated for them in respect of any relevant fail.

417. As for depot breaks, my present view is that it is those clients who have not had depot breaks resolved by the delivery of securities to them whose client money entitlements may need to be adjusted upwards, for the reasons set out in paragraphs 320 to 321 above. I acknowledge however that the question of depot breaks may need further examination, if the Administrators consider that my tentative conclusions in this respect offer insufficient or unreliable guidance, in relation to a matter not fully explored at the hearing.

Question

14. If the answer to question 13 above is "no":

(a) Is a client money entitlement defeasible by reason of events occurring since the Time of Appointment?

(b) Can delivery of a security discharge the obligation on LBIE to pay (in whole or in part) a distribution from the CMP?

Answer

418. (a) A client money entitlement may be (*pro tanto*) defeasible by reason of the resolution since the Time of Appointment of fails for which a specific amount had previously been segregated for the relevant client. Apart from that, no client money entitlement is defeasible by reason of events occurring since the Time of Appointment.

(b) Delivery of a security by way of resolution of a fail may therefore discharge the obligation on LBIE (or other trustee of the CMP) to pay a distribution from the CMP, to the extent of the amount previously segregated in respect of that fail.

Reasons

419. My reasons for these conclusions are fully set out in paragraphs 276 to 335 above.

420. I should add that cash receipts (in satisfaction of client money entitlements) by a client from LBIE's house accounts between the PLS and the Time of Appointment will also have to be brought into account by clients against any client money entitlement in their favour disclosed by the last internal reconciliation as at the PLS. See paragraphs 268 to 269 above. This potential adjustment does not appear to be the subject of any specific question, but I mention it for completeness.

Distribution of client money

Question

24. Is LBIE obliged or permitted to make a distribution from the CMP to those clients entitled to receive one in the currency of its choice and, if not, in what currency or currencies should distribution be made?

25. If LBIE is obliged or permitted to make a distribution from the CMP to those clients entitled to receive one in the currency of its choice, is LBIE obliged or permitted to calculate the amount to be paid to each such client as follows:

(a) by applying his rateable share of the CMP as established in accordance with the procedure proposed in question 22 above to the value of the CMP as at the date of distribution;

(b) by establishing the value of the CMP as at the date of distribution by reference to a spot exchange rate on that day.

Answer

421. LBIE is entitled in its discretion to make distributions from the CMP in any appropriate currency, provided that it thereby distributes each client's share in an amount referable to the common currency referred to in question 22 above, converted to the currency of distribution (if different from the common currency) at the rate prevailing at the time of distribution. In so doing, LBIE will apply the rateable share of the CMP as established in accordance with the procedure proposed in question 22 above to the value of the CMP as at the date of distribution.

Reasons

422. The distribution rules do not in my judgment prescribe a currency of distribution, so that LBIE may distribute in such appropriate currency or currencies which it identifies as a matter of the exercise of a reasonable discretion. Nonetheless the requirement that the distribution should be *pro rata* the relevant client money entitlements necessitates that a distribution in a currency other than the common currency should confer neither a benefit nor a detriment upon the recipient client, by comparison with a distribution in the common currency.

Question

25A. Where a client money entitlement is referable to an underlying obligation of LBIE (for example where, at the Time of Appointment, LBIE owed money to the client ("the Debt") but had segregated a sum equal to the amount of the Debt, does the client's distribution from the CMP discharge the Debt:

(a) to the full extent of the client entitlement referable to the Debt;

(b) to the extent of the distribution made in respect of such entitlement;

(c) not at all; or

(d) to some other and, if so, what extent?

Answer

423. The answer to this question depends upon the precise terms of the contracts between LBIE and its clients pursuant to which the Debt (as defined) was created. None of those contracts have been examined in the course of this application.

424. Subject to that, and in the absence of any contractual provision to the contrary, the starting point should be that a client's personal claim in debt against LBIE would be abated only to the extent of the amount actually distributed to that client from the CMP in respect of the debt in question.

Reasons

425. On the assumption that a particular debt ought to have led to the segregation of a specific amount (albeit not necessarily the appropriate amount) in LBIE's segregated accounts, the reasons why a client may obtain less than full satisfaction for his debt by distribution from the CMP will arise from shortfalls caused either by LBIE's default, in under-segregating or de-segregating, by the expenses of distribution, or by credit risks such as the Bankhaus failure. Generally, I can see no good reason in principle why the client's personal contractual entitlement should be reduced by reference to those shortfalls, rather than merely being abated by the amount of the relevant distribution. The only potential exception which occurs to me at the moment is the credit risk shortfall, in relation to which the possibility that this may not be LBIE's fault, and the possibility that the contractual relationship provides for, or accommodates, the principle in CASS7.9 that, in such circumstances (absent a PPE), LBIE would have been entitled to write down the relevant client's entitlements, suggests that a full contractual analysis may give rise to a larger abatement.

426. Beyond that, the absence of the relevant contractual materials, or any submissions in relation to them, make it impossible for me to pursue this analysis further.

Affiliates

Question

26. Is LBIE obliged under CASS7 to treat money held for an affiliated company as money held in the course of or in connection with its MiFID business?

26A Does it make any, and if so what, difference if the affiliated company has a contractual entitlement that money held for it will be held as client monies?

Answer

427. It is now agreed that question 26 should be answered in the affirmative, so that question 26A does not arise.

428. The answer to question 26 is, as I have already stated, without prejudice to any contractual provision between LBIE and a relevant affiliate to the contrary, or to the consequences of any aspect of the course of their mutual dealings which might adversely affect the affiliate's right to insist upon the performance of that obligation.

CONCLUSION

429. It ought to be possible for the parties to frame a form of order giving effect to my answers to the questions contained in the last section of this Judgment. If not, I will hear submissions as to an appropriate form of order, and in any event in relation to costs.