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Investment firm insolvency: reform of the client money distribution and special administration regimes

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Introduction

The law on the insolvency of financial services firms is changing. Although these firms can and do become insolvent, their importance to the proper functioning of financial markets means that special rules should apply. Accordingly, the Financial Conduct Authority and HM Treasury implemented, and are now in the course of amending, secondary legislation and regulation with the aim of ensuring that these firms wind down, or are rescued, in ways that promote the soundness of the financial markets.

These rules have a direct effect on how much money clients recover in insolvency proceedings in respect of investment firms. However, while the current rules have been useful, some high profile cases have shown there is room for improvement. Here, we explain the pre-existing rules, the problems so far, and the most notable changes on the horizon.

In 2016, the FCA published *Discussion Paper DP 16/2: CASS 7A & the Special Administration Regime Review*, and in January 2017 it published *Consultation Paper CP 17/2* on the same subject, which contains draft amended rules to be implemented by the proposed *Client Assets (Client Money and Custody Assets Distribution and Transfers) Instrument 2017*. Meanwhile, HM Treasury in 2016 published *Reforms to the Investment Bank Special Administration Regime* and draft delegated legislation, which on 8 February 2017 was approved by Parliament: *The Investment Bank (Amendment of Definition) and Special Administration (Amendment) Regulations 2017*, which is expected to come into force imminently. These publications and instruments follow a review in 2011 by Peter Bloxham pursuant to the Banking Act 2009.

CASS

The starting-point is the FCA's Client Assets Sourcebook ('CASS'), which comprises rules made under a power granted to the FCA by the Financial Services and Markets Act 2000. CASS imposes duties on firms that have profound effects on insolvency, mainly by prescribing rules for the holding of clients' money and financial instruments with a view to ensuring that they remain outside the firm's general estate and, therefore, are not available to general creditors.

First, a firm is required to register legal title to financial instruments that it

holds for a client in the name of the client or – more likely – in the name of a nominee company (unless an exception applies). The legal effect (assuming the firm complies with the rules) is that the instruments in principle ought not to be part of the firm's general estate in the event of an insolvency.

Secondly, clients' money – comprised for instance of income derived from financial instruments held (e.g. dividend payments from shares or profit from selling instruments) – is protected in special ways. Under the default rules of English law, there would be a risk that, on the firm's insolvency, clients would have to prove like everyone else to obtain a distribution (e.g. in the event that a trust of that money were not properly constituted or in the event of a shortfall), with the usual dangers of incomplete recovery.

A principal objective of CASS is to mitigate this risk by imposing a statutory trust on clients' money received or held by most firms that trade or hold financial instruments. (Different rules apply for regular deposit-taking by banks, not discussed here.)

The CASS statutory trust (CASS 7.17) and the Client Money Distribution rules (CASS 7A) mean that on the firm's insolvency, whatever client money it holds should not be part of the general estate. Instead, all clients' money held by the firm is pooled on the commencement of an insolvency proceeding and is held on trust only for clients, such that each client can make a claim on that client money pool (and, in certain circumstances, sub-pools).

This means that on a firm's insolvency, there are effectively two different estates: the 'client money estate' comprising the client money pool (against which only clients can claim); and the 'general estate' (against which all creditors, including clients (e.g. in respect of shortfall cases), can prove).

The Special Administration Regime

CASS is clearly useful in safeguarding clients' money and instruments. However, the entry into administration of the American investment bank Lehman Brothers – which did a great deal of business from its UK hub – demonstrated that CASS was deficient in a number of key respects.

Despite the hope that clients would regain their money and instruments quickly and efficiently, the *Lehman Brothers* court cases demonstrated that the process had the potential in complex cases to be protracted and costly. The CASS regime assumes compliance with the rules and Lehman Brothers had not complied in a number of ways, including through failures to

segregate for all its clients in accordance with the rules and unsatisfactory records having been kept while the firm was a going concern. As a result, there were difficult legal arguments about a number of complex questions, including, most significantly, what money comprised the client money trust and which clients were entitled to it.

The consensus following the collapse of Lehman Brothers was that administration under Part II of the Insolvency Act 1986 was not fit for purpose for financial services firms. To cure these defects, the Treasury enacted the Investment Bank Special Administration Regulations 2011 ('the SAR') pursuant to its rule-making powers under the Banking Act 2009. The SAR works alongside and interacts with CASS.

The SAR created a bespoke administration regime for investment firms. Despite the use of the phrase 'investment bank' in the SAR, the SAR spreads its net wide, encompassing most firms that allow clients to trade instruments or that hold instruments for clients. So, for instance, an online trading platform that meets the definition of an investment bank will be covered (although deposit-taking by banks is not).

The SAR implemented several changes to a standard administration under Part II of the Insolvency Act 1986 (which incorporates by reference Schedule B1 to the Act). It has different statutory objectives, namely:

- a. return of client money and instruments as soon as is reasonably practicable;
- b. engagement with market infrastructure bodies and regulators in a timely fashion; and
- c. rescue of the firm or liquidation.

The SAR administrators also have special powers, such as more sophisticated bar dates for the return of client instruments (or their value), and powers to disclaim onerous property (which is normally a power reserved to liquidators).

There have been several SAR administrations, such as those for MF Global and Worldspreads. While the SAR and CASS have been useful, there is still room for improvement. Below we explain the problems, and the proposed solutions set out in the above-mentioned publications, proposed CASS amendments and amended SAR.

Valuation of claims

The valuation of claims is changing, which will have a major effect on how much clients can recover. Currently, a client's entitlement to CASS client money is calculated at the date of the entry into the SAR. This is contrary to the 'hindsight principle' under general insolvency law, where more accurate valuations at a subsequent date can be used by an insolvency office-holder to value a claim.

In the *MF Global* SAR litigation, many clients entered into contracts with the firm in which the client took a long or short market position. Many of these contracts remained open at the date of entry into the SAR. Subsequently, those market positions were liquidated, at higher prices. The profiting clients wanted to rely on the hindsight principle to make claims for the higher prices. If they had been successful, they would have been able to increase their claims by \$59 million against the client money pool. The High Court held, however, that the hindsight principle did not apply.

The FCA is proposing to change the CASS valuation so that the hindsight principle applies to cleared open margined transactions, by inserting a new rule, CASS 7A.2.5R(-2). This seems fairer, and also should reduce tactical decisions by clients to make additional claims in the general estate, where the hindsight principle does apply.

Recovery of interest

The money in the client money pool does not attract interest. This is in contrast to claims against the general estate, where statutory interest accrues at 8% (being the rate applicable under the Judgments Act 1838).

In the Lehman Brothers administration – where, unusually, the bank ultimately was able to pay all its debts to third party creditors – this created a possible anomaly. A client who made a claim against the client money pool was denied interest. However, it is at least arguable that the same client could instead submit a 'normal' unsecured claim against the general estate in the administration, which would include statutory interest (which, in some cases, amounted to many millions of pounds). These are complex questions, still to be resolved, about whether it is possible as a matter of insolvency law for a client to surrender its client money claim in this way and effectively "opt in" to a claim against the general estate (not least because of the likely effects vis-à-vis other creditors in a normal case).

Irrespective, such issues have the potential to cause substantial delays to the administration because some clients may seek to wait and see whether the general estate will pay out more than the client estate.

To reduce the potential delays, the amended SAR reg.10I provides that a claim in the general estate will only pay interest on the part of the debt not recoverable from the client money pool. This seems both fairer and more efficient.

Bar dates and speed of distribution

The original SAR contains a bar date allowing the administrators to distribute client instruments on the basis of claims actually received by a given date. Any client who misses the bar date can make a late claim against remaining assets, but cannot claim against instruments already distributed in good faith. This process is helpful for ensuring prompt distributions to clients.

However, the original SAR has some problems. First, the bar mechanism applies only to client instruments, not client money. Secondly, the mechanism does not allow the client estate to be closed completely.

The amended SAR regs 12A-12E will allow bar dates for client money, and create a hard bar date, after which any remaining assets can be moved to the general estate, and the client estate can be closed completely. This should help ensure that the administrators do not incur costs of maintaining the client estate at a time when it is unlikely that anyone further will make a claim against it. To ensure clients are given reasonable notice of the hard bar date, the FCA is proposing amendments to CASS at 6.7.2R-6.7.7R and 7A.2.6AR-7A.2.6RE.

By contrast, a previous suggestion to allow a speedy return of some client money and instruments based on the books and records of the firm at the time of insolvency has not been taken forward. The aim was to ensure that some assets were returned promptly. However, the FCA and the Treasury consider there to be too many risks (including that the records are inaccurate) so that the clients who have genuine entitlements do not receive distributions. This seems sensible, on the basis that it is commonly the case that a company which is nearing insolvency has not been fully compliant with certain requirements, including in relation to record-keeping and segregation.

Tracing claims

Because client money is held under a trust, if money that should be in the client money pool has been transferred to the firm's own or "house" accounts (sometimes referred to – confusingly, from the perspective of English trusts law – as "proprietary" accounts), the client money estate may have a claim against the general estate for breach of trust, and seek to identify (or 'trace') the money. (The obverse position is that the general estate may also have a claim for recovery of money that erroneously entered the client money estate.) When faced with such issues, administrators may seek to resolve the competing claims by applying to court, not least because doing so will help protect them from future challenge by aggrieved creditors or clients.

The FCA is considering whether to create a set of rules to replace tracing or to allow such settlements to take place without a court order. An obvious advantage of such a rule would be to save costs, but the rule would need to have safeguards to ensure that the value of the tracing claim, which may well run to many millions of pounds, is settled at a fair value. Exactly how this would work remains undecided and, as with valuation issues in insolvency scenarios more generally, it is unlikely to be straightforward. A partial solution may however be provided by amended SAR reg.10H, which HM Treasury has implemented to allow an administrator to top up client money shortfalls from a firm's own account as part of a final reconciliation that has not taken place but would have been due before the entry into administration.

Transfer of positions

The Treasury and the FCA are also implementing a mechanism to allow the client money pool and client instruments to be transferred from a failing firm to a different, solvent firm. The amended SAR reg.10B sets out a mechanism for this in the form of a novation of contracts *en bloc* by operation of law (i.e. without client consent being a prerequisite to such novations proceeding and overriding any restrictions on transfer in the underlying contractual documents).

It is also being proposed that CASS will be amended so that the client money pool could be transferred (currently possible only in limited circumstances): see the proposed amended CASS 7A.2.4R(4). These proposals have broad parallels in the long-standing rules in the United States for insolvencies of brokerage firms, under the Securities Investor Protection Act 1970.

In 2016, the FCA had proposed that the entire client money pool rather than parts only should be transferred. This was to avoid a scenario where client

money to which certain clients' entitlements relate is transferred to a new firm to the detriment of other clients, whose entitlements would remain owed by the failed firm. In January 2017, the FCA in *CP 17/2* amended its proposal so that a transfer of a client's (or some clients') entitlement to the client money pool would be allowed as long as other clients would not receive less than they would otherwise receive. This should allow more flexibility for insolvency office-holders to effect business transfers involving client money, so long as the pro-rated nature of entitlements on the pooling of client money is not disturbed.

A transfer mechanism is to be welcomed because in appropriate cases it should provide continuity for clients by minimising the disruption caused by the investment firm's failure and may help minimise the risk of disputes that might otherwise arise. However it remains to be seen how often it will be capable of being invoked in practice, particularly where the failed firm's records are poor or incomplete, or if there is a risk of the remaining clients receiving a lesser distribution because of a partial transfer. Furthermore, experience in cases such as Lehman and MF Global suggests that it may be problematic for responsible insolvency office-holders in larger insolvencies to reach a conclusive determination about the impact of any partial transfer on the remaining clients, which is likely to serve as a disincentive to effecting such a transfer.

Costs

The position to date has been that the costs of administering the client estate are borne by the client estate, which reduces actual distributions to clients. The Treasury and the FCA intend that costs incurred as a result of breaches of CASS should be borne by the general estate (as reflected in amended SAR reg.19A(4)). This certainly increases client protection, although the effect is that the distributions to general creditors could be significantly reduced. The SAR also gives the court a discretion to allow clients to recover their own costs from the general estate (reg.12F).

Conclusion

The imminent SAR amendments and the proposed CASS changes discussed above are to be welcomed; for the most part, they seek to strike a fair balance between clients and other creditors, and they should speed up the process of return of client money and instruments in the event of a firm's

failure.

Nevertheless, some issues are merely being considered, and remain undefined. Furthermore, the reported court cases suggest that the prevailing uncertainties around the scope of the rules as they stand – and the likely tests that will face the new rules, once enacted – will bring further complex litigation in the future on the interpretation and application of CASS and the SAR. Indeed, *CP 17/2* acknowledges the possibility of future litigation relating to the types of claim that a firm's clients can bring following the failure of the firm. For these reasons, the changes, while welcome, are unlikely to be the last word on the interaction and crossover between insolvency, property and trusts law and financial services-related legal and regulatory issues.

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