

Lehman client money judgment – impact on MF Global clients

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On 29 February 2012 the Supreme Court of England and Wales dismissed the appeal by GLG Investments and ruled that clients whose money had not been properly ring-fenced when Lehman Brothers International (Europe) (“LBIE”) went into administration could now have access to the segregated pool of money alongside those clients whose money had been actually segregated by LBIE. This ruling, by a majority in the Supreme Court, directly impacts not only LBIE clients but also MF Global UK (“MFG UK”) clients and has more general implications both for financial institutions providing client money protection and for their clients.

The ruling in brief

The court dismissed an appeal by hedge fund GLG Investments that the pool of segregated funds should only be distributed to clients whose money had been segregated by LBIE. The appeal centred around how client money should be defined and subsequently distributed in the event of the insolvency of the regulated firm providing client money protection (a “primary pooling event”). The court ruled on three key points:

1. **When does client money protection begin?** The court ruled that protection of client funds (afforded by way of a statutory trust) arises upon receipt of the client money. Protection is not dependent on the institution actually segregating the money in accordance with the “normal” or “alternative” approaches in the FSA’s CASS 7 rules.
2. **Is client money held in unsegregated house accounts pooled with client money held in client money accounts?** The court ruled that the pool of money available for distribution on insolvency should be all funds which are readily identifiable as client money. For money to be available for distribution as client money, it is not necessary that the funds are placed in an account segregated from the firm’s own funds.
3. **Is participation in the client money pool dependent on the client’s funds having been segregated?** The court held that the key to establishing whether a client has a claim to funds in the client money pool is assessing their “*actual and objective entitlement . . . it has nothing to do*

with the amount which may or may not have been segregated". In other words, if a client's money has not been segregated but he was entitled to client money protection, that client can nonetheless share in the distribution of the client money which is collected and pooled.

Lord Hope reasoned that *"it is unlikely that client money which had yet to be segregated [under these rules] was intended to be treated differently from client money which had been segregated"*.

Impact of the Lehman ruling on the distribution of MFG UK client funds

KPMG, the special administrators of MFG UK, have commented that the judgment:

"is likely to result in a substantially reduced percentage payout from the client money pool as the money will be shared out amongst a much larger number of claimants . . . including clients who were entitled to have client money segregated for them as at the date of [MFG UK]'s administration, irrespective of whether [MFG UK] had in fact segregated client money for them prior to its administration".

The special administrators have warned that the ruling creates some uncertainty as to who is entitled to participate in the client money pool, which in some instances may need to be decided in court.

KPMG also commented, in a press release immediately following the judgment, that in developing their interim distribution model all eventualities of the Lehman ruling were accounted for, stating that the distribution method can withstand the decision and nothing will need to be recouped as a result of the decision.

The Lehman rule clearly has important implications for MFG UK clients and for the progress of the MFG UK special administration.

- Clients whose funds were not segregated but which were entitled to client money protection (and who had not signed up to terms and conditions in which they agreed their funds would not be treated as client money) will be entitled to share in the distribution of client money which is pooled.
- The existence of clients whose funds should have been segregated but were not is likely to reduce the percentage payout from the client money pool. The extent to which there are clients in

that position may depend, in part, on how robust MFG UK's procedures were for complying with the client money rules. It will be interesting to hear the special administrators elaborate on why they consider that a "substantially reduced percentage payout" is now likely and in particular whether the US trustee's claims on behalf of MK Global in the US will be treated as client money claims.

- The ruling may slow down distributions because of the time that will have to be taken to evaluate claims to client money protection from clients whose funds were not segregated and to trace client money held in house accounts. Tracing client money is difficult and may not result in additional recoveries if the client money has been dissipated or cannot be identified. In the LBIE case, tracing client money in house accounts is likely to be an extremely arduous task as LBIE used the FSA's "alternative" approach to client money protection under which LBIE paid client money into a house account. We have not seen any indications that MFG UK also used this approach.

The full implications of the judgment will be analysed by the MFG UK special administrators over the coming days and we expect further information to be released to MFG UK clients soon.

We have a dedicated team, with expertise in insolvency, financing, financial markets and commodities trading advising clients with assets, positions and other dealings with MF Global. If you have dealings with or exposures to MF Global and would like help with this evolving situation, please contact Georgia Quenby or Brett Hillis in London or Andrew Cross and Andrea Pincus in New York.

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