Applicant
A P Clark
Third Statement
"APC3"
16 July 2009

IN THE HIGH COURT OF JUSTICE **No. 7942 of 2008**

CHANCERY DIVISION

COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

THIRD WITNESS STATEMENT
OF
ANDREW PETER CLARK

I, ANDREW PETER CLARK, of PricewaterhouseCoopers LLP, Plumtree Court, London EC4A 4HT, state as follows:

1 I am a partner in PricewaterhouseCoopers LLP ("**PwC**"), a firm of accountants at the above address. I am one of the partners assisting the joint administrators of Lehman Brothers International (Europe) ("**LBIE**") (in administration).

2 My partners, Steven Anthony Pearson, Anthony Victor Lomas, Michael John Andrew Jervis and Dan Yoram Schwarzmann are the joint administrators of LBIE (together the "**Administrators**") who were appointed as such by order of Mr Justice Henderson on 15 September 2008. I am duly authorised to make this witness statement on behalf of LBIE and the Administrators.

3 There is now shown to me a paginated bundle of copy documents, marked "**APC3**", to which I refer in this witness statement. Where no cross reference to the paginated bundle is provided and where there is no other indication of the source of my information or belief, the contents of this witness statement are derived from facts and matters which are within my own knowledge and belief. These facts and matters have been learned either as a result of the work undertaken by me in

assisting the Administrators of LBIE, or they have been provided to me either by my partners and colleagues at PwC involved with the administration of LBIE, or by the employees of LBIE who are still available to the Administrators, or by the Administrators' legal advisers, Linklaters LLP ("**Linklaters**").

4 I make this statement in support of an application (the "**Application**") for directions to clarify the status of certain cash received and held by LBIE after the date of administration. In particular, the Administrators are seeking directions as to whether, in certain circumstances, cash received and held by LBIE is held on trust for a client or clients, whether as a result of the statutory trust under the client money rules (as set out in the Client Assets Sourcebook ("**CASS**") issued by the Financial Services Authority (the "**FSA**")) (the "**Client Money Rules**"), the applicable contractual framework or otherwise, and/or whether the receipt of such cash gives rise to a liability on the part of LBIE to account to the client in full in respect of such amount, by way of administration expense or otherwise, and/or whether the client has a personal claim in respect of such cash.

5 The precise form of the directions sought is whether, and if so in what circumstances:

5.1 on the true construction of clause 5.2 ("**Clause 5.2**") of LBIE's standard form International Prime Brokerage Agreement: Charge Version (the "**Charge IPBA**") the client of LBIE ranks as an unsecured creditor of LBIE in respect of cash received by LBIE subsequent to the time of the Administrators' appointment, where such cash (a) is paid or distributed in respect of securities which were, as at 07:56 on 15 September 2008 (the "**Time of Administration**"), held by LBIE as custodian pursuant to clause 17.1 of the Charge IPBA and (b) is received by LBIE in respect of a corporate event or action in respect of such securities which occurred after the Time of Administration (such cash being "**Post-Administration Cash**"); or

5.2 on the true construction of Clause 5.2 Post-Administration Cash is held on trust for the client, whether (a) pursuant to the terms of the Charge IPBA, and/or (b) pursuant to the FSA's rules relating to client money and/or (c) under a constructive trust and/or (d) on some other basis (subject in each case to any deductions which LBIE is entitled to make pursuant to the terms of the Charge IPBA or otherwise); or

5.3 the Administrators are permitted to procure LBIE to pay Post-Administration Cash to the client (subject to any deductions which LBIE is entitled to make pursuant to the terms of the Charge IPBA or otherwise) as an expense of the administration or on any other basis.

6 Post-Administration Cash falls into the following broad categories:

6.1 cash received by LBIE as a result of securities held by LBIE for a client being redeemed or having matured;

6.2 cash received by LBIE as a result of securities held by LBIE for a client having been tendered under a tender offer;

6.3 cash received by LBIE as a result of a rights issue in respect of securities held by LBIE for a client; or

6.4 cash received by LBIE as income (for example, by way of dividends or coupons) on securities held by LBIE for a client.

Cash paid or distributed (whether prior to or after the Time of Administration) in respect of securities held for clients by LBIE in the circumstances outlined above is referred to in this statement as "**Cash Proceeds**". The event giving rise to the Cash Proceeds (whether occurring prior to or after the Time of Administration) is referred to in this witness statement as a "**Corporate Event**".

7 This Application will involve, among other things, a determination as to the true scope and effect of (i) CASS 7.2.3R (a copy of which is at **page 9 of APC3**); and (ii) Clause 5.2 of the Charge IPBA (a copy of which is at **page 90 of APC3)**.

8 This Application is not intended to deal with all aspects of cash received by LBIE. A separate application addressing a number of points relating to client money and the interpretation of the Client Money Rules was issued on 1 May 2009 (the "**Client Money Application**"). The Court has directed that the Client Money Application be adjourned until 15 and 16 July 2009 at which hearing the Court will fix a date for a hearing or hearings at which the Court will, amongst other things, give directions on the issues raised in that application.

9 In particular, this Application is not intended to deal with the status of Cash Proceeds received by LBIE prior to the Time of Administration. The Administrators do not currently believe that guidance is needed as to the correct treatment of such Cash Proceeds. Nor does this Application deal with the status of Cash Proceeds received by LBIE after the Time of Administration relating to Corporate Events that

occurred prior to the Time of Administration. That issue may or may not require determination, depending on the Court's decision on this Application and what sums (if any) are at stake, which is not yet certain.

10 Nor is this Application intended to deal with the status of Cash Proceeds received by LBIE after the Time of Administration, where the Cash Proceeds relate to securities which were not, as at the date of the Corporate Event, held by LBIE as custodian pursuant to clause 17.1 of the Charge IPBA.

11 This statement is divided into 3 sections:

A. Introduction and Background

B. Regulatory Framework

C. The Relevant Contractual Framework

12 Nothing in this witness statement is intended to waive privilege in respect of any matter referred to and privilege is not being waived.

A. INTRODUCTION AND BACKGROUND

LBIE's prime brokerage business and prime brokerage documentation

13 One of LBIE's major business areas was prime services, where LBIE acted as prime broker to institutional clients, mostly hedge funds. LBIE's prime brokerage business was complex and multi-faceted. It provided trade execution, financing, clearing, processing and custodial services to LBIE's hedge fund clients. The prime brokerage business had in excess of 900 prime brokerage clients and in the region of 1400 prime brokerage accounts. LBIE used a variety of largely standard form documents in the course of conducting business with its prime brokerage clients. It thereby sought to ensure a broadly consistent position on fundamental principles governing those client relationships, although inevitably some clients would negotiate amendments on a case by case basis.

14 Generally speaking, the agreement governing the prime brokerage relationship was a version of the LBIE International Prime Brokerage Agreement ("**IPBA**"). There are in broad terms two different types of IPBA: the title transfer IPBA (the "**Title IPBA**") and the Charge IPBA. LBIE's prime brokerage clients (other than U.S. clients) were generally a party to one or the other – more often than not the latter. As described in more detail below, most of LBIE's clients that entered into the Charge IPBA did so prior to the implementation of the Markets in Financial Instruments Directive ("**MiFID**"), as explained at paragraph 38 below). Post-MiFID, the form of Charge

IPBA was amended. The post-MiFID version is exhibited at **pages 86 to 135 of APC3**. The pre-MiFID version is exhibited at **pages 136 to 185 of APC3** and it (and the differences between the two, insofar as relevant to this Application) is explained in section C below. References in this witness statement to the defined term "Charge IPBA" are to the post-MiFID version (except where otherwise indicated).

15 I am advised that, under the Title IPBA, title in securities delivered by the client to LBIE passed to LBIE (an example of the Title IPBA in use prior to LBIE's administration is exhibited at **pages 186 to 209 of APC3**). By contrast, the Charge IPBA provided that all securities held by LBIE for the client were held by LBIE as custodian (see clause 17 at **page 110 of APC3**), subject to a security interest in LBIE's favour (see clause 10 of the Charge IPBA at **page 96 of APC3**) and, in the majority of cases, subject to LBIE having an extensive right of use (referred to also as a right to re-hypothecate) over the securities (see clause 11 of the Charge IPBA at **page 100 of APC3**). This right entitled LBIE to borrow, lend, dispose of or otherwise use for its own purposes any securities by transferring them to itself or to any other person (without giving notice to the client).

16 I am advised that, under the Charge IPBA (and in contrast to the Title IPBA), a client has a proprietary interest in relation to securities held by LBIE for it. I understand that, upon the exercise of LBIE's right of use of any securities, the client's proprietary interest in those securities is considered to have been extinguished. LBIE would cease to act as custodian in respect of such securities, but would have a contractual obligation to account to the client for equivalent securities.

17 The position in relation to cash held under the Charge IPBA is different. The Charge IPBA contains a provision, Clause 5.2, which I understand sought to take advantage of CASS 7.2.3R (and earlier versions of this rule) (the "**Collateral Exemption**"). The Collateral Exemption is described in more detail at paragraphs 46 to 48 below.

18 Clause 5.2 of the IPBA provides:

> *"The parties acknowledge and agree that any cash held by us for you is received by us as collateral with full ownership under a collateral arrangement and is subject to the security interest contained in the Agreement. Accordingly, such cash will not be client money pursuant to the Rules (or any successor provisions thereto) and will not be subject to the*

protections conferred by the Rules. Such cash held by the Prime Broker will not be segregated from the money of the Prime Broker or any other counterparty of the Prime Broker and will be held free and clear of all trusts. The parties further agree that the Prime Broker will use such cash in the course of its business and the Counterparty will, therefore, rank as a general creditor of the LBIE in respect of such cash."

19 Broadly, the effect of this provision is, I am advised, to exclude or otherwise prevent a client from having a proprietary entitlement in respect of all cash held, including where the cash in question is paid or distributed in respect of securities held by LBIE as custodian.

Process for dealing with cash proceeds pre-administration

20 Under clause 5.1 of the Charge IPBA, LBIE agreed to open and maintain cash accounts and securities accounts for its clients. Prior to its administration, LBIE used an internal system known as the "ITS" system to record amounts credited and debited to its clients' cash accounts (and indeed its securities accounts). I also understand that the ITS system recorded whether an account was afforded client money protection pursuant to the Client Money Rules. Accordingly, pre-administration, the status and balance of a client account could be ascertained by LBIE from ITS.

21 Prior to its administration, LBIE held assets (both securities and cash) through a number of different custodians and depositaries (including affiliates). I understand that, as a general rule, LBIE held European securities through sub-custodians not affiliated with LBIE and which are not insolvent. However, in respect of non-European securities, my understanding is that it was not uncommon for an affiliate within the Lehman group of companies to act as sub-custodian for LBIE. Where this was the case, it would be the affiliate (and not LBIE) that would have the direct relationship with the relevant depositary, e.g. the Deposit Trust Company in the United States ("**U.S.**"). Assets were often held through a chain of custodians and sub-custodians.

22 Following the occurrence of a Corporate Event, Cash Proceeds would be credited to the relevant accounts maintained at the depositary ultimately holding the securities. Where a sub-custodian held securities for LBIE (who in turn held securities for its clients) the depositary would credit the sub-custodian accounts (using information from its books and records), and the sub-custodian would credit the LBIE account (using information from its books and records). LBIE would then

use the ITS system in order to ascertain which clients should be credited in LBIE's books and records with respect to a particular Corporate Event. This would at various intervals be reconciled against the cash accounts held by LBIE with its sub-custodian or depositary.

Cash proceeds received post-administration

23 Since the Time of Administration, LBIE has received, and will continue to receive, a significant amount of cash paid or distributed as a result of corporate events and actions in respect of assets held by LBIE as custodian, both in relation to securities held under the Charge IPBA and under other agreements pursuant to which LBIE holds securities for clients. As at the date of this witness statement, LBIE has, since the Time of Administration, received approximately US$2.6 billion of cash arising out of Corporate Events. While a significant proportion of the US$2.6 billion of cash received relates to 240 bond redemptions, the Administrators' current understanding is that approximately 30,000 dividend and coupon income payments have been received since LBIE went into administration, totalling approximately US$820 million. These amounts will continue to increase as LBIE's administration continues.

24 Not all of the US$2.6 billion received relates to securities held under the Charge IPBA. Some of this cash has been generated as a result of Corporate Events occurring in respect of securities held pursuant to pure custody arrangements (although I am advised by my colleagues that this represents only approximately 5% of the cash received). Some of this cash has also been generated as a result of Corporate Events occurring in respect of securities held in LBIE's proprietary (or "house") accounts, e.g. pursuant to full title transfer arrangements such as securities transferred under the Title IPBA (I am advised by my colleagues that this represents approximately 30% of the cash received). In addition, and as explained in further detail below, not all Charge IPBA clients will have agreed to the Clause 5.2 Collateral Exemption applying in respect of the entire balance on their cash accounts with LBIE.

25 Importantly, these figures do not include Cash Proceeds relating to securities that are not currently within the control of LBIE, most notably, Cash Proceeds relating to securities that were (and still are) held through an affiliate of LBIE such as Lehman Brothers Inc (a U.S. entity in an insolvency process in the U.S.). Although the Administrators have no way of knowing with any degree of certainty (given that the affiliates in question are themselves subject to insolvency processes and so are not

conducting business or cooperating with LBIE in the same way that they would have been prior to the commencement of their insolvency processes), it is their expectation that Cash Proceeds relating to securities held through affiliates will continue to be received into accounts held by those affiliates with custodians or depositaries. As these accounts are held in the name of the affiliate rather than the name of LBIE, neither LBIE nor the Administrators are able to access information about the accounts or require the ultimate custodian or depositary to transfer balances in those accounts to LBIE. Ultimately, the receipt of cash from those affiliates will depend on the outcome of the insolvency processes to which those affiliates are subject.

Process for dealing with cash proceeds received post-administration

26 The Administrators have designated a team of PwC and LBIE employees to deal specifically with Corporate Events. That team is divided into two sub-teams: the first deals with what are termed "corporate actions", such as cash received in relation to a rights issue, tender offer or redemption proceeds (the categories outlined at paragraphs 6.1 to 6.3 above), and the second deals with income, such as that received from dividends and coupons (the category outlined at paragraph 6.4 above).

27 Following LBIE's administration, the Administrators have been arranging for the transfer of securities from the pre-administration sub-custodians (or so called "legacy depots") into accounts at a new custodian (the "**New Custodian**"). Generally, the accounts set up post-administration with the New Custodian mirror those formerly held with the legacy depots. At present, the majority of European securities are deposited with the New Custodian, but there are still some securities deposited with the legacy depots.

28 For securities deposited with the New Custodian, when a Corporate Event is going to occur, the Administrators' corporate actions team is notified that a Corporate Event is going to occur through the New Custodian's notification system. The Cash Proceeds are held by the New Custodian in cash accounts linked to the securities account in which the related securities are held. Where securities are held on behalf of LBIE or its clients by an affiliate, instructions may have been issued for actions to be taken but LBIE has not received confirmation that such instructions have been actioned. Cash Proceeds received in respect of those securities is not currently being fully processed into LBIE's ITS system.

29 As LBIE is not currently in a position to close accounts and transfer clients balances

to third party prime brokers (if so requested by a client) for the reasons explained in paragraphs 30 and 31 below, the Cash Proceeds have been received post-administration regardless of whether or not the client has purported to terminate the Charge IPBA and regardless of whether or not the client has instructed LBIE to return or transfer the underlying securities giving rise to the Cash Proceeds. In some cases, the client in question will have liabilities to LBIE or an affiliated company (arising out of the Charge IPBA and/or another contract between the parties). In other cases, there may be no liabilities owed (and, in some cases, no prospects of liabilities being owed).

30 In the first witness statement of Steven Anthony Pearson made in support of an application by the Administrators for directions regarding the procedures and processes to be followed in the administration ("**Pearson 1**"), Mr Pearson explained in detail the reasons why LBIE is not in a position to return securities as requested by certain of its clients (see section E of Pearson 1). As Mr Pearson also explained, the task of dealing with proprietary claims is a complicated one. The Administrators are mindful of the importance of this task from the point of view of the clients (who understandably want to secure the return of monies and assets to which they claim an entitlement as soon as is realistically possible). However, it is also critical to the achievement of the statutory purpose of the administration that the Administrators neither (i) return to clients assets to which LBIE has a claim or which LBIE is entitled to retain pending discharge of any debts owed to LBIE nor (ii) part with monies and assets to which LBIE (or the other companies within the Lehman Brothers group) has no claim but to which there are, or might be, competing claims by two or more clients, until such claims are resolved. While a significant amount of assets are now within LBIE's control, many are not, including for instance those held through affiliates, the treatment of which will be determined, in part at least, by the insolvency processes to which those affiliates are subject (as noted in paragraph 25 above.

31 The Administrators are working to resolve the issues in respect of client assets outlined in paragraph 30 above in accordance with the directions laid down by the Court in its order dated 7 October 2008 so as to be able to return client assets as soon as possible. The return of property held in the name of, or otherwise to the order of, LBIE which is subject to trust or proprietary claims has been and remains a key priority for the Administrators. However, until such property is returned, the volume of Post-Administration Cash will continue to increase.

32 The current intention is to deal with certain assets held by LBIE which are or may be subject to trust or proprietary claims by clients by way of a scheme of arrangement under Part 26 of the Companies Act 2006 between LBIE and persons who are its creditors in relation to such property. In this regard, on 25 February 2009, Steven Pearson made a second witness statement ("**Pearson 2**") in support of an application by the Administrators for directions that the Administrators be at liberty to propose a scheme of arrangement in relation to Trust Property (as defined more fully at paragraph 9 of Pearson 2). At paragraph 136 of Pearson 2, Mr Pearson informed the court that the Administrators would be applying to the Court for directions on various issues that have arisen in the administration to date. One such issue (as detailed at paragraph 136.2.4 of Pearson 2) is the subject of this Application, i.e., whether certain arrangements in relation to money held on behalf of clients falls within the scope of the Collateral Exemption such that cash received pursuant to such arrangements should not be considered to be client money pursuant to the Client Money Rules or otherwise treated as Trust Property. As can be seen from paragraph 136 of Pearson 2, this is one of several applications to be issued relating to points of construction of contractual documentation and/or the Client Money Rules. Another application anticipated in paragraph 136 of Pearson 2 is the Client Money Application referred to in paragraph 8 above. On 12 March 2009, a further witness statement was filed with respect to the application for directions regarding the scheme of arrangement in relation to Trust Property. On 14 July 2009, a Part 8 Claim Form and an application for directions were issued in respect of the proposed scheme of arrangement.

33 Although the primary focus of the proposed scheme of arrangement is the return of client securities and related matters, it is also intended that the scheme should deal with claims in respect of Post-Administration Cash. It will do so in a manner consistent with the determination of this Application.

34 As indicated above, Clause 5.2 on its face appears to bring all Cash Proceeds (including, therefore, Post-Administration Cash) within the Collateral Exemption such that cash is not required to be held as client money under the Client Money Rules. Given that Clause 5.2 provides for full ownership of cash held for a client to pass to LBIE, I am advised that it would also appear that the Charge IPBA precludes the existence of an express trust arising in respect of Cash Proceeds (including Post-Administration Cash). Accordingly, on the face of it, it appears that the client has no proprietary interest in respect of Cash Proceeds and would instead have a personal debt claim in respect of sums standing to the credit of the client's

cash account. However, in the course of the Administrators' ongoing dialogue with clients, it has become apparent that there is an argument that the Post-Administration Cash should, notwithstanding Clause 5.2, be paid in full to LBIE's clients. Given that, as explained in paragraph 23 above, the sums involved are large and that the Administrators have been advised that the status of the Post - Administration Cash is not altogether clear, the Administrators have concluded that the prudent course is to seek clarification and directions from the Court on this issue.

35 The Administrators have been working to identify suitable respondents to be parties to this Application to ensure that, so far as possible, the competing arguments are made in a manner helpful to the Court. Despite continued efforts, the Administrators have not yet been able to identify and agree the participation of respondents in this Application. They continue to take steps in this regard and are currently in discussions with various potential respondents.

B. REGULATORY FRAMEWORK

36 In this section I explain the Regulatory Framework for the Collateral Exemption within which, it appears, the Cash Proceeds fall so as to exclude a proprietary claim by a client. The information in this section is based on that provided to the Administrators by my legal advisers, Linklaters.

37 LBIE is authorised and regulated by the FSA and, as such, it is required to comply with the FSA Handbook and Rules, including CASS, the Client Assets Sourcebook, which sets out the FSA's rules on the handling of clients' assets including client money. The relevant section of CASS for the purposes of this Application is "Chapter 7: Client Money Rules". .

38 I am advised that Chapter 7 of CASS was recently amended by the FSA, with the changes taking effect on 1 January 2009. These changes were made primarily to merge the FSA's different client money and custody requirements applying to firms that are subject to MiFID and firms that are not subject to MiFID, so as to simplify standards and align the rules for all investment firms. MiFID is an EU Directive, which provides a harmonised regulatory regime for firms providing investment services across the EEA, including therefore LBIE. MiFID was implemented in the UK with effect from 1 November 2007. References to CASS 7 in this witness statement are to the rules contained in the pre-2009 version of CASS, with the corresponding reference in the post-2009 version footnoted (except where the

reference is the same in both versions). A copy of Chapter 7 of the post-2009 version of CASS and the pre-2009 version of CASS appear at **pages 1 to 47 and 48 to 85 of APC3**, respectively.

Meaning of client money

39 Following the recent amendments to the CASS rules, the differences in treatment between MiFID and non-MiFID firms have been greatly reduced although certain significant differences still remain. I am advised that none of the changes are relevant to this Application. Expressions with defined meanings in CASS appear in italics therein. The *emphasis* in the extracts from CASS quoted in the following paragraphs is as contained in CASS itself.

40 From 1 January 2009 the definition of "client money" can be found in the FSA's Glossary and is defined (for the purposes of Chapter 7 of CASS) as "*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*". I refer to **page 209a of APC3** which contains the relevant extract from the FSA Glossary. "Client money" was defined in the same way pre-January 2009, albeit the definition was contained in CASS itself.

41 "Money" is defined in the FSA's Glossary as "any form of money, including cheques and other payable orders". I refer to **page 210 of APC3** which contains the relevant extract from the FSA Glossary.

42 "Client" is defined in the FSA's Conduct of Business Sourcebook ("**COBS**") at Rule 3.2.1 as any *person* to whom a firm provides, intends to provide or has provided (a) a service in the course of carrying on a "*regulated activity*"; or (b) in the case of MiFID business, an ancillary service. I refer to **page 211 of exhibit APC3** which contains the relevant extract from COBS. A list of regulated activities is set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (as amended), a copy of which appears at **pages 212 to 330 of APC3**, and includes most types of dealings in investments. A list of ancillary services is set out in Section B of Annex I to MiFID, a copy of which appears at **pages 331 to 332 of APC3** and includes the provision of custody services and certain foreign exchange services.

Basis upon which client money is held

43 Pursuant to CASS 7.7.2R[1], "a *firm* receives and holds *client money* as trustee". A client therefore has a proprietary interest in client money as defined by the CASS

[1] see **page 27 of APC3** for the post-2007 version and **page 70 of APC3** for the pre-2007 version

Rules. I am advised that the trust is created by CASS pursuant to a statutory power to do so conferred by section 139 of the Financial Services and Markets Act 2000 and is therefore commonly referred to as a "statutory trust". I refer to **pages 333 to 334 of APC3** which contains the relevant extract from the Financial Services and Markets Act 2000.

44 Pursuant to CASS 7.3.1R[2], "a *firm* must, when holding *client money*, make adequate arrangements to safeguard its *client's* rights and prevent the use of *client money* for its own account". In particular, client money is required to be segregated by a firm in a client bank account pursuant to CASS 7.4.1R[3].

Exemptions to the Client Money Rules

45 CASS provides certain exemptions to the Client Money Rules such that, in certain limited circumstances, money held by a firm (in this case LBIE) is not held pursuant to the statutory trust.

46 I am advised that the relevant exemption for present purposes is CASS 7.2.3R[4], defined at paragraph 17 above as the Collateral Exemption. Pursuant to CASS 7.2.3R, "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*".

47 I understand that, prior to the implementation of MiFID in the UK, firms were entitled to agree with certain clients (on account of, amongst other things, their level of sophistication) that the Client Money Rules would not apply, an arrangement commonly known as the "professionals opt-out". I understand that the professionals opt-out was widely used.

48 The guidance at CASS 7.2.4G[5] makes clear that a title transfer financial collateral arrangement under the Financial Collateral Directive (Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements) is an example of the type of transfer of money to cover obligations where that money will not be regarded as client money.

Effect of the administration on the Client Money Rules

49 I am advised that certain events, including the administration of a firm, constitute a

[2] see **page 14 of APC3** for the post-2007 version and **page 57 of APC3** for the pre-2007 version

[3] see **page 15 of APC3** for the post-2007 version and **page 58 of APC3** for the pre-2007 version

[4] see **page 9 of APC3** for the post-2007 version and **page 53 of APC2** for the pre-2007 version

[5] see **page 9 of APC3** for the post-2007 version and **page 53 of APC2** for the pre-2007 version

"primary pooling event"' for the purpose of the Client Money Rules. Accordingly, when LBIE went into administration on 15 September 2008, a primary pooling event occurred. CASS provides that the following should happen when a primary pooling event occurs:

49.1 client money held in each client money account in the firm at administration is pooled and is required to be distributed so that each client receives a sum rateable to the client money entitlement calculated under CASS 7.9.7R[6];

49.2 client bank accounts are required to be opened pursuant to CASS 7.9.9R to receive all client monies received by LBIE after the primary pooling event; and

49.3 client monies received after the primary pooling event are required to be returned to the relevant client without delay pursuant to CASS 7.9.9R.

50 Because money held prior to administration pursuant to the Collateral Exemption is, I am advised, not to be regarded as client money, it does not form part of the client money pool to be distributed to clients with valid claims on that pool (in accordance with CASS 7.9.6R[7]). Clients do not have any proprietary claim in respect of such money. Pre-administration, LBIE would, I am advised, simply owe a debt in the amount of such money to the relevant client (i.e. the client has an unsecured personal claim).

51 Neither CASS nor the Collateral Exemption is expressly stated to cease to apply to LBIE on administration or on the occurrence of a "primary pooling event". It appears therefore to be possible for money to be transferred to LBIE by or for a client post-administration and for this to fall within the Collateral Exemption. The effect of this would be that:

51.1 Cash received post-administration (not being client money) need not be returned to the client pursuant to CASS 7.9.9R.

51.2 LBIE would simply owe a debt in the amount of such cash to the client, who would at first sight be a general unsecured creditor in respect of that money.

52 It is therefore essential for the Administrators to ascertain whether certain of the cash LBIE receives or holds is to be treated as client money or whether it falls

[6] see **page 74 of APC3** for the pre-2009 version. The corresponding provision in the post-2009 version is 7A.2.5R, which can be found at **page 40 of APC3**

[7] see **page 74 of APC3** for the pre-2009 version. The corresponding provision in the post-2009 version is 7A.2.4R, which can be found at **page 40 of APC3**

within the Collateral Exemption. If it does fall to be treated as client money then, subject to LBIE's security rights under clause 10, the money is required to be returned to the client. If it is not client money, the cash will, on the face of it (and unless it is deemed to be held on trust or otherwise payable to the client on some other basis (subject to LBIE's security rights)), form part of the general estate of LBIE and thus be available for general distribution, with the client having a claim as a general creditor in respect of the amount of cash owing to it.

C. THE RELEVANT CONTRACTUAL FRAMEWORK

53 The Administrators need clarity on how the regulatory principles referred to above apply to money received in the circumstances outlined at paragraph 6 above in the context of LBIE's contractual relationship with its clients under the Charge IPBA.

54 Pursuant to clause 5.1 of the Charge IPBA (see **pages 89 to 90 of APC3)**, LBIE is required to open and maintain one or more "Cash Accounts", as described at paragraph 20 above. A "Cash Account" is defined in the Charge IPBA as "*an account for the payment of cash made and received (or deemed to have been received) pursuant to [the Charge IPBA]...*". Such Cash Accounts are required to be:

54.1 debited with the amount of any Loan and all cash paid or deemed or treated as paid by [LBIE] to or on behalf of the Client; and

54.2 credited [with] all cash paid or deemed or treated as paid to [LBIE], by or on behalf of the Client (including sums received by [LBIE] in settlement of a transaction established between the Client and a third party.

Equivalent provisions exist with regard to the Securities Accounts (as defined in the Charge IPBA).

55 I understand that the client is obliged, under clause 6.2 of the Charge IPBA, to ensure that at all times its positions had a positive value of not less than the Margin Requirement (as defined in the Charge IPBA) set by LBIE (see **page 90 of APC3**).

56 I also understand that, under clause 8.1(b) of the Charge IPBA, where income is paid on securities "*standing to the debit of a Securities Account*" in respect of securities delivered or treated as delivered to LBIE by a client, LBIE is to credit an equivalent amount to the relevant Cash Account.

57 Clause 7.1 of the Charge IPBA provides that, upon reasonable request, LBIE is to repay the client any cash standing to the credit of a Cash Account. There are exceptions to this obligation under clause 7.2 of the Charge IPBA, such as where an Event of Default (as defined in the Charge IPBA) or a Potential Event of Default (as defined in the Charge IPBA) has occurred or is continuing, or where LBIE is entitled to apply the cash standing for the time being to the credit of a Cash Account to reduce or eliminate certain obligations owed by the client to it.

58 Pursuant to clause 10.1 of the Charge IPBA, the client charges in favour of LBIE (i) all securities which are held by LBIE on behalf of the client; (ii) all securities held by any other Lehman Company (as defined in the Charge IPBA); (iii) all cash held by LBIE on behalf of the client and (iv) any net close-out amount payable to the client by LBIE under any Customer Agreement (as defined in the Charge IPBA). These charges are given as security for all liabilities of the client to LBIE, or to any Lehman Company, under the IPBA, the Customer Agreements, any other contracts or otherwise.

59 Pursuant to clause 11 of the Charge IPBA, LBIE has a broad right of use in respect of securities and may borrow, lend, charge, hypothecate, dispose of or otherwise use for its own purposes any securities by transferring such securities to itself or to another person without giving notice of such transfer to the client. Sometimes the agreement was amended to set a limit on the extent to which securities could be hypothecated. I understand that any such limit was usually expressed as a percentage (often 140%) of the client's indebtedness to LBIE. Where the right of use was exercised, I am advised that the client would cease to have a proprietary interest in the securities concerned. LBIE would instead be contractually obliged to transfer "securities equivalent to those securities" to the client upon request.

60 Pursuant to clause 17 of the Charge IPBA, with the exception of any assets transferred to LBIE pursuant to clause 11, any securities debited to the Securities Account (as defined in the Charge IPBA) are held by LBIE as custodian, and the client appoints LBIE and LBIE agrees to act as its custodian in accordance with the terms of Schedule 2 to the Charge IPBA.

61 Clause 5.2 sets out the basis upon which cash is transferred to LBIE and seems to contemplate bringing all money held by LBIE for a client within the Collateral

Exemption. An example of the wording of the post-MiFID version of Clause 5.2 is set out at paragraph 18 above.

62 I understand that the wording of Clause 5.2 is the standard wording generally contained in the post-MiFID versions of the Charge IPBA entered into with LBIE and its clients. In some cases, LBIE agreed that if it was holding cash and assets for the client in excess of the client's Margin Requirement (as defined in the Charge IPBA) under the Charge IPBA (a "Margin Excess"), cash comprised in the Margin Excess would be treated as client money. This took the form of an amendment to Clause 5.2, either in the Charge IPBA itself or in a subsequent deed of amendment to it.

63 I understand that most of LBIE's clients entered into the Charge IPBA with LBIE prior to the implementation of MiFID. The pre-MiFID version of the Charge IPBA provided at clause 5.2 :

> *"The parties acknowledge and agree that cash held by the Prime Broker will not be client money pursuant to the Rules (or any successor provisions thereto) and will not be subject to the protections conferred by the Rules. Such cash held by the Prime Broker will not be segregated from the money of the Prime Broker or any other counterparty of the Prime Broker and will be held free and clear of all trusts. The parties further agree that the Prime Broker will use such cash in the course of its business and the Counterparty will, therefore, rank as a general creditor of the Prime Broker in respect of such cash."* (see **page 143 of APC3**).

64 I also understand that LBIE sent a form of letter (the "**Collateral Letter**") to its clients who had entered into the pre-MiFID version of the Charge IPBA in order to reflect the MiFID regime. The relevant part of the Collateral Letter was in the following terms (and is exhibited at **pages 335 of APC3**):

> "*This letter is supplemental to the International Prime Brokerage Agreement entered into between us (the Agreement). The purpose of this letter is to make certain changes to the Agreement as set out in the following paragraph. These changes are required as a result of the Markets in Financial Instruments Directive (MiFID) which came into force on 1 November 2007.*
>
> *You acknowledge and agree that any cash held by us for you is received by us as collateral with full ownership under a collateral arrangement and is*

subject to the security interest contained in the Agreement. Accordingly, such cash will not be client money pursuant to the FSA's rules (the Rules) and will not be subject to the protections conferred by the Rules. Such cash held by us will not be segregated from our money or the money of any other counterparty and will be held free and clear of all trusts. You agree that we will use such cash in the course of our business and you will, therefore, rank as a general creditor of us in respect of such cash.

If you carry on dealing with us after 1 November 2007, such dealing will signify your agreement to the above."

65 As can be seen, the words of Clause 5.2 and of the Collateral Letter recite the acknowledgement and agreement of both parties that cash held by LBIE for the client:

65.1 is received by LBIE as collateral with full ownership under a collateral arrangement;

65.2 will not be client money pursuant to the FSA Rules (as defined therein);

65.3 will not be subject to the protections conferred by the FSA Rules (as defined therein);

65.4 will not be segregated from the money of LBIE or any other client;

65.5 will be held free and clear of all trusts;

and that the client will rank as general unsecured creditor of LBIE in respect of such cash.

66 On their face these provisions are very broad. They appear to cover any cash, howsoever and at whatever time it arose (i.e. whether it be pre- or post-administration).

67 Also, the obligations that are being secured are very broad, covering present or future, actual, contingent or prospective obligations. The intended effect of the wording appears to be that cash is not held on trust. If there is no trust, the client does not have a proprietary interest in the cash and only has a claim as a general creditor.

68 It appears to be clear from the close correspondence between the wording of Clause 5.2 and the wording of the Collateral Exemption itself that the clause was intended to evidence reliance on that exemption.

69 The Court should also be aware that certain of LBIE's prime brokerage clients (predominantly its U.S. clients) are party to an agreement called a Margin Lending Agreement (a copy of the standard form of which is at **pages 336 to 343 of APC3**). I am advised that the Margin Lending Agreement also contains a clause (clause 7(d)) which seeks to take advantage of the Collateral Exemption and is in materially the same terms as Clause 5.2. The Margin Lending Agreement is generally governed by New York law, although clause 7(d) is in many of the post-MiFID versions stated to be governed by English law.

CONCLUSION

70 As set out at paragraph 35 above, the Administrators have sought to identify suitable respondents to be parties to this Application to ensure that, so far as possible, the competing arguments are made in a manner helpful to the court. As detailed at paragraph 35 the Administrators and their advisers continue to work to identify respondents and agree their participation in this Application.

71 In all of the circumstances, the Administrators respectfully invite the Court to give directions pursuant to paragraph 63 of Schedule B1 of the Insolvency Act 1986 in relation to the matters set out in the Application and at paragraph 5 above:

STATEMENT OF TRUTH

I believe that the facts stated in this witness statement are true.

Signed: .....

ANDREW PETER CLARK

16 JULY 2009

16 July 2009

Applicant
A P Clark
Third Statement
"APC3"
16 July 2009

No. 7942 of 2008

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

WITNESS STATEMENT OF ANDREW PETER CLARK

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